Banking on the public: market competition and shifting patterns of governance

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The financial crisis that started in 2007 has put the inherent challenges posed by global financial markets in a multilevel governance setting in sharp relief. It prominently raised the question why it apparently was not possible to develop a governance pattern better equipped to mitigate the worst effects of the crisis. In more formal terms: What explains the relationship between market structure and patterns of governance, so as to understand the dynamics of the global financial system? This thesis develops an innovative approach to address this issue. It is argued that an integrated notion of states and markets can further our understanding of the global financial system. Both public and private actors exert agency on markets and in the policymaking process in a simultaneous fashion, and a focus on either markets or states ('politics') therefore falls short in explaining the dynamic in the system. The case studies on the policymaking processes addressing international bank capital adequacy standards (the Basel Capital Accords) and sovereign debt crisis resolution provide the empirical backing for this argument. Overcoming the state-market dichotomy not only leads to better analysis, it also points to new and important avenues for reform. This thesis therefore provides a timely analytical and socially relevant contribution.

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Banking on the Public Market Competition and Shifting Patterns of Governance

J.G.W. Blom

Banking on the Public

Market Competition and Shifting Patterns of Governance

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Banking on the Public

Market Competition and Shifting Patterns of Governance

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Jasper Gerardus Willibrordus Blom
geboren te Alkmaar

…the owl of Minerva begins its flight only with the onset of dusk…
Hegel, Elements of the philosophy of right

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Abbreviations

BCBS	Basel Committee on Banking Supervision
BoE	Bank of England
BIS	Bank for International Settlements
BRICs	Brazil, Russia, India and China
CACs	Collective Action Clauses
CAD	Capital Adequacy Directive (EU)
CMCG	Capital Markets Consultancy Group (IMF)
CoGC	Code of Good Conduct (on Sovereign Debt Re-Negotiation)
CSO	Civil Society Organisation
ED	Executive Director (here: of the IMF)
EFSF	European Financial Stability Facility (EU)
EMCA	Emerging Markets Creditors Association
EMTA	Emerging Markets Traders Association
ESM	European Stabilisation Mechanism (EU)
FDIC	Federal Deposit Insurance Corporation (US)
FSAP	Financial Sector Assessment Programme (IMF)
FSF	Financial Stability Forum (now: Financial Stability Board)
GAB	General Arrangements to Borrow (IMF)
GDP	Gross Domestic Product
HI	Historical Institutionalism
IDDC	International Debt Discount Corporation (professor Kenen)
IET	Interest Equalization Tax (US)
IFI	International Financial Institutions (IMF plus MDBs)
IIF	Institute of International Finance
ILSA	International Lending Supervisory Act (US)
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (formerly: Interim Committee)
IPE	International Political Economy
IPMA	International Primary Market Association
IRB	Internal Ratings Based (approach, Basel II)
ISDA	International Swap and Derivatives Association
LiA	Lending into Arrears (IMF)
MBS	Mortgage-Backed Securities
MDB	Multilateral Development Bank
MNC	Multi-National Corporation
MYRA	Multi-Year Rescheduling Agreement
NIE	New Institutional Economics
NPV	Net Present Value
OECD	Organization for Economic Cooperation and Development
PCG	Principles Consultative Group
PIGS	Portugal, Ireland/Italy, Greece, and Spain
PSI	Private Sector Involvement
QIS	Quantitative Impact Study (BCBS)
SDRM	Sovereign Debt Restructuring Mechanism (IMF)
SIA	Securities Industry Association
SME	Small and Medium-sized Enterprise
SPV	Special Purpose Vehicle
VaR	Value-at-Risk (models)
VFCR	Voluntary Foreign Credit Restraint (US)

Foreword and acknowledgements

This thesis marks the end of a journey. And what a journey it was. At times trying, mostly very pleasant, and always inspiring (especially due to the people I met along the way). Along the road to a better understanding of the political economy of the global financial system and more generally International Political Economy, we stumbled upon the biggest global financial crisis since the Great Depression of the 1929s, adding an urgent layer of relevance to the research. In that sense, it couldn't be a better time to reach the end of the travels.

Along the way, I received excellent guidance. First and foremost, I was guided by Geoffrey Underhill, a great political economist with a perfect overview of the terrain of financial governance. If there is one person I owe the success of this PhD trajectory to, it would be him. Your advice never failed to challenge me to sharpen my own thinking and deepen my insights. Moreover, you were very generous in offering opportunities for interesting detours such as edited volumes and visiting scholarships. Beyond the academic, it was also a pleasure to share a good glass of wine and discuss the academic *habitus*, current affairs, and the history of live, the universe, and everything. In short, it was a privilege to work with you and I look forward to future endeavours.

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While I was going about the world of global finance, I tried to retain my Alkmaar roots as it was always a pleasure to hang out with my friends from 'back home.' That kept me grounded, and I am fortunate that you accepted that all too often I missed out because academic duties called. The same goes for my family, you have supported me throughout. The support of Sarah in the last two years was unrelenting, and I am very grateful for her patience with me. I am happy to have you in my live, and as I have said often before: good times lie ahead.

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Chapter 1

Shifting patterns of governance, changing market structures, and public-private interaction

Global financial governance and the challenges of financial crises

On Friday, 27 July 2007 Mr Stefan Ortseifen, CEO of the Düsseldorf-based IKB Deutsche Industriebank, came to work facing a difficult day. The day before, Deutsche Bank and others had restricted their credit lines to IKB.[1] Although German regional banks are traditionally relatively small and oriented towards the Small and Medium-sized Enterprises (SME) sector, this specific regional bank had engaged in investments in so-called 'structured products'. These investments had run into trouble, which led other banks to tighten their credit lines. This threatened the liquidity of IKB and feverish negotiations ensued throughout the weekend between Mr Ortseifen, IKB's main shareholder KfW (a state-owned bank), the German authorities (Ministry of Finance and the German banking supervisor BaFin) and the various German banking associations. On Monday, 30 July an ad hoc official statement by IKB announces a profit warning and a €3.5 billion rescue package as well as the immediate dismissal of Mr Ortseifen. KfW financed 70 per cent of the rescue package, with the remaining 30 per cent provided by other German banks. One of the members of KfW's Board of Directors assumes Mr Ortseifen's duties.

Although this seems quite a typical story of a bank running into murky waters and public authorities coming to the rescue by hastily arranging a 'marriage' with a more solvent financial institute – a story which could have been situated anywhere else just as well as in Düsseldorf – a closer look at the mechanisms behind IKB's demise shows how it exemplifies the broader financial crisis which was unfolding at the time.

The structured products that triggered IKB's troubles were underpinned by American mortgages, reflecting the global integration of financial markets. The closer look should therefore start with the changes in the pattern of governance of the American mortgage market and the reaction of market participants to these changes. The changing patterns of gover-

[1] The following anecdote from the current financial crisis only serves to illustrate the relevance of the questions asked in this thesis, and in no way aims to give a full account or even to touch upon the most important events. It is based on more elaborate accounts in Blom, 2010. See also Gamble, 2009 and Schwartz, 2009 for in-depth analyses of the crisis and Sorkin, 2009 for a gripping journalistic account.

nance date back more than a decade, as both Presidents Clinton and Bush Jr were – for very different reasons – enthusiastic proponents of homeownership among Americans. To this end, Clinton changed the Community Reinvestment Act forcing banks to provide more mortgages to disadvantaged minorities in 1995. Bush Jr continued this policy as part of the Republican narrative of the 'ownership society'.[2] This resulted in a significant growth of euphemistically called 'subprime' mortgages – home loans to people with a dubious capacity to repay. This growth was further fuelled by the development and growth of markets for securitised mortgages. Mortgage providers would 'package' subprime mortgages in so-called Special Purpose Vehicles (SPVs) whereby Mortgage-Backed Securities (MBS) are sold in the capital markets to finance the 'acquisition' of the package of mortgages. By securitising mortgages, the financial risk of (subprime) mortgages is taken off the balance sheet of the original mortgage providers, and is replaced by liquid funds from the SPV. Under global bank capital adequacy standards (the Basel Capital Accord), this meant banks no longer had to hold capital for these mortgages. Instead, through the global capital markets the risks could be spread all around the world, including to a small regional bank based in Düsseldorf.

As the hot air inflating the bubble of American housing prices (new entrants on the housing ladder keeping demand high combined with low interests rates) ran out, strains started to show in the spring of 2007.[3] These strains were exacerbated by the Federal Reserve, which had started to increase interest rates to stem inflationary pressures. This confronted current homeowners with higher repayments (as subprime mortgages were commonly characterised by varying systems of flexible rates).[4] Foreclosures began to rise, but it took until July 2007 for the public to realise how badly the American housing market had been affected (and how widespread the impact might be): bulge bracket investment bank Bear Stearns announced that two of its hedge funds had lost nearly all of their value due to losses on investments in (subprime) MBS. The announcement of Bear Stearns sent a first shock through the interbank loan market. Financial institutions no longer had confidence in each other, as any institution might have toxic assets on its books and might therefore run into similar financial difficulties in the future. It was these dynamics that eventually led banks to tighten IKB's credit lines, as this bank too had (indirect) investments in subprime MBS.

IKB Deutsche Industriebank is, however, only one example of a financial institution requiring a 'liquidity injection' during the crisis. The malaise was much, much broader. Early 2008 saw declines in prices on the housing market as well as on stock markets around the world. Another shock announcement almost sent already jittery markets off the cliff: in September 2008 Lehman Brothers announced huge losses and was forced into bankruptcy. The consequent shockwave through the financial markets required financial authorities in most OECD countries to increase 'liquidity injections' and bank bailouts, and led governments to design

[2] Engelen, 2010, p. 211-212.
[3] Schwartz, 2009 points to the importance of these new entrants in inflating the bubble.
[4] Van Ewijk & Teulings, 2009, p. 11-12.

massive stimulus packages funded by public resources to prop up the real economy. This arguably saved the financial sector from a total meltdown and dampened the effect of the private demand contraction. However, it also led to a significant deterioration of fiscal balances and ramped up sovereign debts as states took on private debt to rescue the markets.

Almost ironically, with the immediate danger to the private financial sector subsiding after massive state support, market actors shifted their attention to risks in the public sector. They started focusing on the Eurozone's periphery, the rather derogatorily named PIGS (Portugal, Ireland/Italy, Greece and Spain) countries. Early in 2010, doubts about Greece's solvency led to a rise in its risk premium to almost prohibitive levels, effectively barring Greece's access to the capital market. This forced the Greek authorities to seek financial assistance from official sources (as opposed to private market financing). After being involved in the bailout of banks like IKB, the German Ministry of Finance found itself once more cobbling together emergency rescue packages, but this time with the International Monetary Fund (IMF) and other EU member states. This time sovereign states and not banks had to be pulled back from the brink of bankruptcy. The IMF provided support programmes to a range of countries, the success of which is all the more important when we realise that a comprehensive mechanism for an orderly resolution of sovereign bankruptcies is still found wanting and that recovering banks hold large amounts of sovereign debt.

Although this most recent financial crisis certainly was one of the more spectacular in history, rocking the corridors of power on Wall Street and beyond, its effects were in no way restricted to the world of *haute finance*. The crisis had an impact on socio-economic structures in countries the world over. For example, the British Overseas Development Institute estimates that an additional 50 to 100 million people have fallen into poverty due to this arguably 'Western' financial crisis.[5] If there is one thing this crisis has shown, it is that the global integration and expansion of the financial system enabled rapid spillovers and contagion of financial problems, leading to grave global repercussions.

While the most immediate phase of the current crisis seems to be behind us, policymakers have started taking stock of the damage and to discuss proposals for reforming financial governance to prevent future crises. There are many proposals for reform as the crisis has spread across the global financial system, with many factors contributing to its scale and scope. One noteworthy initiative were the further negotiations on global bank capital adequacy standards, leading to a third version of the Basel Capital Accord (Basel III). This accord aims to address some of the problems signalled above regarding off-balance sheet activities of banks. A second initiative was to increase the size of the IMF to enhance its capability to come to the aid of countries hit by the crisis (US$ 750 billion have been pledged by the G20 to this end). In the European Union, a new European Financial Stability Facility is similarly aimed at addressing sovereign debt problems such as the PIGS countries are facing. Finally, there

[5] Te Velde et al, 2010.

are initiatives aimed at regulating the over-the-counter derivatives markets and 'alternative investment funds', as well as bonuses in the financial sector.

The current crisis, as with other large-scale crises before it, highlighted for scholarly and public debate many salient issues in the dynamics of the global financial system. To give a rough demarcation of the terrain this thesis will cover, it should be noted that the dynamics of the global financial system entail the development of the markets for finance *and* their governance. The global financial system refers to the (international) system for the allocation of different forms of credit.[6] It concerns who gets credit, how it is provided and how the relations between creditors and debtors are designed and managed. The development of the market for finance is understood as the terms of competition for creditors and debtors exchanging credit (finance) in the market, while financial governance refers to rules and regulations shaping the behaviour of actors in the market.[7] The examples of current policy initiatives mentioned above are elements of global financial governance and are aimed at shaping behaviour away from those actions that arguably contributed to the crisis.

Explanations of the current and other crises seem to allocate different weights to problems of either governance or market developments.[8] To put it in crude terms: is IKB's Mr Ortseifen to blame for making reckless investments under competitive pressure, or is German Finance Minister of the time Mr Steinbrück to blame for underwriting flawed banking regulation? In contrast, the brief discussion of the run-up to the crisis above instead raises the question whether this separation into market versus governance causal stories is a valid understanding of events, or whether it might only be an analytical tool that actually obfuscates what is really going on in the global financial system (and hence leading to inadequate explanations). Mr Ortseifen clearly made ill-advised investments, but in addition to being under competitive pressure he was also incentivised by the governance pattern for which Mr Steinbrück was responsible (the Basel II Capital Accord). The terms of competition are influenced as much by the rules and regulations affecting the market as by the actions of firms, while changes in these terms of competition also spur changes in these rules and regulations (as witnessed by the current policy initiatives mentioned above).

There consequently seems to be something about the interaction between changes in governance of financial markets and changes in the terms of competition in the markets that contributed to the crisis: governance and market structure are bound up with each other. Nor is this a recent problem; the growth and internationalisation of financial markets has historically been accompanied by recurrent financial crises.[9] It seems therefore that in order to understand why attempts to establish a governance pattern that mitigates financial crises have

[6] Strange, 1996.
[7] These concepts will be elaborated and embedded in the literature in the next chapter.
[8] Engelen, 2010 develops this point for the current crisis and shows how there are several narratives about the crisis each focusing on different causal mechanisms.
[9] Bordo et al. 2001. See also Kindleberger & Adler, 2005 and Reinhart & Rogoff, 2009 for financial crises from an historical perspective.

been less than fully successful, we must better understand the *relationship* between market structures and patterns of governance. The central question informing this project is therefore:

> *What explains the relationship between market structures and patterns of governance so as to understand the dynamics of the global financial system?*

As mentioned above, the apparently reciprocal relationship between market structures and patterns of governance seems to be a key defining factor in the development of the global financial system. If this hunch is correct, we should not only understand the dynamics of these two, but also their interaction by tracing over time the process of change in the global financial system. The past decades of cross-border and cross-sector integration of financial markets might be understood as occurring symbiotically with the concurrent shifting patterns of governance. As will be elaborated below, this research will explore this general concern by focusing on the issue areas of bank capital adequacy standards and the resolution of sovereign debt crises. The overarching question above can consequently be broken down into three more specific research questions:

1. How has the pattern of governance shifted in the two policy domains of bank capital adequacy standards and sovereign debt crisis resolution over the period 1980 - 2005? How have the relevant market structures changed over the same period?
2. What are the characteristics of the policymaking process leading to these shifts in the pattern of governance of the two policy domains in global financial governance?
3. What is the role of the policymaking process in both shifts in governance and changes in market structure? In short, how do shifting patterns of governance relate to changes in market structure in each of the two cases?

From these research questions three sets of sub-questions can be derived. A first set of sub-questions concerns how we can characterise the rules and regulations shaping actors' behaviour in the period of study (roughly 1980 – 2005); in other words, an operationalisation of 'shifting patterns of governance' and 'changing market structures'. What dimensions are there to patterns of governance? How have the terms of competition in the relevant financial markets changed, for example reflected in market concentration, internationalisation and cross-market integration? The answers to this set of sub-questions will provide the building blocks for an answer to the first research question.

A second set of sub-questions relates to the dynamics of the policymaking process. Who is responsible for shifts in governance and why? How are the relevant policymaking institutions constituted, and how can we characterise the actors and their motivations in these institutions? As the research questions imply, we not only need to look at public actors (government and state agencies) but also at market actors. These market actors can come from the private sector, but also consist of state agencies active in the market, for example those that form the demand side on the sovereign debt market. What is then the relationship between the different types of (public and private) actors within this policymaking process? What are the preferences of the different actors and on what are they based? And whose preferences have been satisfied by the outcome of the evolving negotiations in these international policy networks? Addressing these questions will work towards an explanation of how governance patterns have changed as a result of the policymaking process, and how we can characterise the policymaking processes.

A final set of sub-questions explores the relation between the outcome of the policymaking process in terms of shifting patterns of governance and changing market structures. How does the outcome of the policymaking process influence the terms of competition on the financial markets? How does it change the incentives for market actors? Who benefits from the outcome of the policymaking process? In turn, what impact does the outcome of the policymaking process have on the policy preferences of the actors as market structures change? This will provide the building blocks for the answer to the third research question.

Through these detailed questions on the preferences and actions of the agents involved in the global financial system, we can address the central question that informs this thesis. As mentioned above, this will be accomplished by exploring the research questions across two case studies, one on bank capital adequacy standards and one on sovereign debt crisis resolution. These case studies will be introduced in the following section, delineating them and showing how these cases provide analytical leverage on the questions at hand.

In answering these research questions, this project will make a number of novel contributions to scholarship. First of all, the relationship between governance patterns and market structures will be conceptualised in a theoretically innovative fashion, overcoming the (implicit) dichotomy between the two which prevails in much of the literature. This will show the limitations of a focus on either policymaking processes or market interactions alone, and will lead to a better understanding of the search for optimal patterns of governance in the context of the realities of power relationships among a diverse range of actors which are simultaneously interacting on markets and trying to satisfy policy preferences. Overcoming the state-market dichotomy contributes to bringing bundles of literature on financial governance from Economics and Political Science closer together, effectively bridging them in an interdisciplinary fashion. This contribution consequently has general relevance for International Political Economy (IPE) scholarship.

A second contribution, related to the first, will be the attention granted to the interaction of both public and private actors in the analysis of global and domestic policymaking processes. This is a novel approach particularly at the global level: most studies of international policymaking processes remain either largely intergovernmental (neglecting non-state actors), or focus on private authority. By focussing on the interaction between public and private actors on both the domestic and global level, this thesis will furthermore contribute to the debate on the role and agency of the state in globalising markets.

A third major contribution lies in the empirical process tracing of the two case studies. Comprehensive studies, based on a consistent analytical framework, of the policymaking processes in the domains of bank capital adequacy standards and sovereign debt crisis resolution are wanting. Some literature has emerged discussing recent episodes in these policy domains[10] but this has not yet been extended to the developments in the wake of the current financial crisis. Moreover, the present study contributes to the existing literature by building on the historical context by tracing the cases from the Latin American debt crisis and the Basel I Capital Accord. This allows for a fuller and richer analysis of the complex causal chain which is developed in this research and which is crucial in understanding the dynamics of the global financial system.

Finally, as the current financial crisis gives new urgency to the two policy domains that are the focus of this study, a timely contribution to the policy debate can be made. As noted, the global financial system has an important impact on societies, which has been underscored once again by the current crisis. Adverse developments in the financial system can have substantial negative effects on economic growth and adversely affect income distribution (with the poor hit hardest). Few topics therefore have greater societal relevance at this juncture than that of the failure of financial governance to prevent or mitigate large-scale crises. The first step in achieving a governance pattern better equipped to promote stability is a better understanding of the realities and dynamics of the emerging global-level policymaking process and how this relates to the dynamics of market instability. The approach taken in this study and the empirical findings will promote such an improved understanding. The results of this study will therefore also be highly relevant for policymakers, as well as for the general public trying to grasp what has been happening since 2007.

But the contribution of this study will not be limited to just a retrospective explanation of policymaking processes. The analysis will show where the room for agency lies in order to demonstrate where we can steer the developments in governance to outcomes that are more closely linked to the public good of financial stability and the preferences of a broader range of stakeholders and citizens (as they should be in a democracy). Global financial governance is at a crossroads, and this thesis will contribute to our understanding of the choices we face, the trade-offs involved in making those choices and the potential obstacles to obtaining the desired outcomes.

[10] For Basel II see for example Tarullo, 2008 and for the post-Asia crisis discussions on sovereign debt restructuring see for example Helleiner, 2008 and 2009.

Governing creditors and debtors: bank capital adequacy standards and sovereign debt crisis resolution

To address the three research questions two policy domains in the realm of global financial governance are analysed: the policies regarding bank capital adequacy and those regarding the resolution of sovereign debt crises. These policy domains have been of ongoing importance to both market players and policymakers in the global financial system and have shown simultaneous shifts in governance and market structures. The negotiations on the first Basel Accord started in the early 80s, while the issue of sovereign debt restructuring gained (renewed) traction following the 1982 Latin American debt crisis. There are consequently sufficient changes to shed light on the longer-run relationship between market structure and governance pattern. The cases are thus suitable for the purpose of this study.

The policymaking processes and changes in market structures in both cases are arguably also comparable, as the most important actors in the domains of both cases essentially overlap, i.e. ministries of finance, central banks and internationalised private banks. This is also reflected in the fact that there are linkages and spillovers between the developments in the two cases: developments in one case have economic and political implications for the other. These linkages and spillovers partly result from the fact that financial crises relevant to these policy domains are often linked.[11] For example, the 1997/1998 East Asian crisis gave an impetus to the policymaking process in both cases, leading to new proposals for sovereign debt restructuring and new concerns with respect to contemporary bank capital adequacy rules. A comparable dynamic seems to have occurred when the IMF-coordinated bailout of private banks following the Latin American debt crisis led to calls for stricter banking regulation (culminating in the first Basel Capital Accord). However, also without large-scale financial crises there is linkage, for example the (revised) Basel II Capital Accord is said to have negative implications for the capital flows (specifically bank credits) to developing countries, thereby influencing the propensity for sovereign debt crises.[12]

Notwithstanding the overlap in actors and linkages between the two policy domains, each case has its own independent dynamics (as will be further elaborated below). As a crude summary: the bank capital adequacy standards case saw the successful implementation of a global, public accord, while the sovereign debt restructuring case saw the defeat of a proposal for a global public institution. The same set of actors were responsible for contrasting outcomes, and both cases hence contribute in their own way to our understanding of the wider dynamics of the global financial system. This difference furthermore lies in the fact that one case concerns the capital standards for creditors in their lending decisions (ex ante), while the other is concerned with the response to troubled lending operations (ex post). Whereas the banking supervision case concerns public regulation of private banks, the sovereign debt restructuring case concerns public debtors vis-à-vis, mostly, private creditors. The contrasting dynamics and the different interests of overlapping sets of actors in both cases contribute to a fuller understanding of the system of allocating credit.

[11] Kaminsky & Reinhart, 1999; Reinhart & Rogoff, 2009.
[12] Claessens, Underhill & Zhang, 2008.

To summarise, both case studies taken together are able to provide an answer to the research questions, and combined they provide additional analytical leverage, as will be elaborated in the methodology section in the next chapter. The two cases will first be further elaborated in the following two sections. The descriptions of the case studies have a comparable set-up. First, the political economy of the cases is discussed. Then, the developments over the period of analysis are described in broad strokes. In conclusion, the analytical leverage of each case in response to the research questions is explored. The main arguments that follow from the cases are introduced following the discussion of the cases, and will of course be elaborated in the remainder of the thesis.

Bank capital adequacy standards under the Basel Capital Accords

The first case study concerns the regulation and supervision of the international banking market. Specifically, the focus lies on the bank capital adequacy standards developed by the Basel Committee on Banking Supervision (BCBS). The aim of financial supervision is to prevent banking crises and avoid the associated costs to society. To illustrate the importance of this aim: banking crises in developing countries in the 1980s and 1990s have cost their taxpayers over US$ 1 trillion, which in present value terms equals all development aid transfers during the period 1950 – 2001.[13] Clearly, the prevention of banking crises could have had a huge impact on the socio-economic development of these countries. To clarify the political economy of bank capital adequacy standards, the objective and economic logic of banking regulation and supervision will be explored. Subsequently, the developments in this policy domain since the 1980s will be outlined. These two steps work towards underscoring the relevance of this case with respect to the research questions.

Controlling credit and controlling bank runs

Banks play an important role in the allocation of credit in the financial system. Historically, the banking sector is also characterised by a high degree of state involvement and regulation. This is related to two distinctive features of banks. First, banks have an important role in ensuring the successful functioning of the economy; and secondly, banks are money-creating institutions employing an asset created and guaranteed by states in the form of the national currency. Banking regulation and supervision is hence an obvious domain to explore

[13] Barth, Caprio & Levine, 2006, p. 2.

the relationship between market structures and governance patterns as they involve both public and private actors.

In economic theory, the emergence of banks is explained by transaction costs in the financial system, mainly the costs for creditors of selecting and monitoring credible debtors.[14] These information costs can be reduced by aggregating them within banks, which then function as intermediaries on the financial markets. Banks collect deposits, lend funds to debtors and perform the selection and monitoring tasks. However, this intermediary function also gives banks a powerful position in controlling the allocation of credit. Banks have an information advantage in the financial system. Furthermore, banks are crucial for the functioning of the economy. As Cohen put it, banks are "exceptionally influential – in effect providing the oil that lubricates the wheels of commerce."[15] Without credit, international trade would be very difficult, innovative start-ups would lack funding to grow and young people would not be able to buy a house. A well-functioning banking system consequently has a positive impact on economic development.[16] This control over credit allocation gives banks considerable political significance as actors, and creates contestation about the proper role and functioning of banks.

A second distinctive feature of banks is that they can lend more money than they have as deposits, and in doing so create money.[17] Since banks have less liquidity than they have deposits outstanding, depositors' trust in banks is essential for a stable banking sector. An information asymmetry exists between the depositors (who do not know how much money the bank has in the till, or in formal terms: whether the bank has enough liquidity) and the bank (which does know). Such an information asymmetry is not necessarily stable. The potentially instability of this information asymmetry is exacerbated by the common 'maturity mismatch' on banks' balance sheets: the funds they lend have a longer maturity (e.g. mortgages, which will only be paid back over decades) than the deposits they receive (which are 'calleable', for example in the case of checking accounts). Were depositors to withdraw their money all at the same time (a bank run), the bank would not be able to muster enough liquidity, further fuelling the depositors in their urge to withdraw money. Bank insolvency can hence result from self-fulfilling prophecies: if depositors believe a bank to be insolvent, they will withdraw their money, thereby causing the bank to in fact become insolvent.[18] In the situation of a bank run, the collective interest (keeping the bank solvent) conflicts with the private interest of depositors to safeguard their deposits. The (undesirable) possible outcome of monetary collapse offers a second explanation for the extensive governance pattern that has emerged for banks. This pattern usually combines public supervision of banks ('prudential supervision' aimed at maintaining financial soundness) with some sort of deposit insurance to maintain public trust in the system.

[14] Diamond, 1984.
[15] Cohen, 1986, p. 299.
[16] See Levine 1997 and 2005 for literature reviews of the link between finance and growth.
[17] This money-creating capacity makes them a peculiar type of financial intermediary as it could also be seen as an encroachment on one of the traditional state functions (the monopoly of monetary issuance).
[18] One of the earliest theoretical models of bank runs is Diamond & Dybvig, 1983.

These two distinctive features provide an explanation for the high degree of state involvement in the regulation and supervision of the banking sector, and are reinforced by long historical experience. This is already reflected in the difficulty of entering a banking market, establishing a new bank or expanding an existing bank abroad. More than 80 per cent of countries have specific regulatory requirements for entry into their market (usually more stringent than for starting 'regular' corporations).[19] This demonstrates a very direct relationship between governance pattern and market structure. A second type of bank regulation prevalent in most high-income countries is deposit insurance.[20] Deposit insurance guarantees (small) depositors that they will get their money back in case of insolvency, and hence reduces the incentive for a bank run and the accompanying damage to the economy. It also reflects how a market system functions within the realities of a political environment: 'weak' consumers are protected from the vagaries of a free banking market (the 'widows and orphans' argument for deposit insurance).

Arguably the most important type of regulation related to these distinctive features of banks is the supervision of risks through capital adequacy requirements. Through capital adequacy standards, bank supervisors aim to ensure that banks hold enough capital to act as a buffer against adverse shocks (e.g. a big debtor being unable to repay its debts). Formal capital adequacy standards force banks to keep a specific amount of capital in reserve for credit risks, and are usually seen as burdensome by banks. This type of supervisory measure has significant consequences for the distribution of credit by banks (and hence also for who will receive credit) and the costs of doing business for banks. Moreover, it also has a significant impact on the costs of their lending activities and the terms of competition for banks, both vis-à-vis banks under different supervisory standards and vis-à-vis nonbank financial institutions. The actual practice of capital adequacy requirements is consequently deeply political, as the exact type of supervisory standard (and its inherent trade-offs) has a substantial influence on the economic structure in the banking market, giving rise to wider distributional consequences.

In short, the governance of bank capital adequacy determines who bears the costs of crisis prevention, and how the costs of eventual failure might be distributed. But supervision not only has a distributional impact, the effectiveness of the regulation also depends on the political and institutional context. As we have once more seen with the current crisis, in the face of systemic meltdown the risks and costs of a banking crisis are shifted to the public as ultimate guarantor of the system. The behaviour of supposedly private actors in such an unfortunate situation has huge consequences for the broader economy and the legitimacy of the political process. The case study therefore not only warrants the IPE approach taken in this thesis but also allows for making a contribution to that field. In the following subsection,

[19] Barth, Caprio & Levine, 2006, p. 111. The number is based on a survey conducted in 2002/2003.
[20] Almost 70 per cent of high-income countries have an explicit deposit insurance scheme, compared to only 14 per cent of low-income countries (Barth, Caprio & Levine, 2006, p. 133).

the developments in this policy domain over the period of study (roughly 1980 – 2005) are sketched in broad strokes.

How did bank capital adequacy standards develop: Basel I and II

For the sake of exposition, the developments in this case could be seen to progress in three phases: first the background to and negotiations on the first Basel Capital Accord (Basel I); second the changes in the market structure in response to this new governance pattern; and third the resulting demands for a revision of the Accord which led to a renegotiation and substantial revision into the Basel II Capital Accord. This demonstrates the simultaneous variance over time in both the governance pattern and the market structure in the banking sector, as illustrated by this case.

The fall of the Bretton Woods pattern of governance, as will be elaborated in the third chapter, dramatically changed the market structure for banks. Banks had to get used to a new competitive environment of currency volatility and further internationalisation of the banking sector. Banking crises – sometimes due to losses in the foreign exchange department, as with the high-profile 1974 Herstatt Bank crisis – suddenly turned out to have important cross-border repercussions. The international integration of markets showed national authorities the need for more information sharing and greater cooperation among bank supervisors (instead of the ad hoc approach followed at the time). Banking supervision could no longer be exercised solely at the domestic level.

In response to this new market structure, the central bank governors of the G10 established what is now known as the Basel Committee on Banking Supervision in 1974.[21] Its goal was "to improve supervisory understanding and the quality of banking supervision worldwide."[22] Its first achievement was to ensure a division of tasks between home and host country supervisors of internationally active banks under the Basel Concordat. Over time, the BCBS became the prime global policymaking institution in this domain.

The cross-border and cross-sectoral integration of financial markets led to other challenges for guaranteeing bank solvency as well, for example the huge growth of syndicated loans (loans provided by international consortiums of banks) to emerging markets. When Latin American countries started reneging on these loans in the early 1980s, it turned out that many internationalised banks – especially in the US – had insufficient capital to guarantee solvency (see also the description of the sovereign debt crisis resolution case below). This led to calls in the US Congress for more stringent supervision (given that a public sector bailout of the banks through IMF financing of the debtor countries was necessary).[23] However, the initial proposals by Congress would have implied domestic regulation that would have imposed additional costs on the American banking sector relative to their foreign competitors,

[21] Kapstein, 1994, p. 44.
[22] BIS, July 2006, p. 1.
[23] Reinicke, 1995.

who were operating under different (and sometimes less costly) supervisory arrangements. The American banking sector therefore resisted the calls for a domestic standard in light of its international competitive position. The lobby of the American banking sector (supported by the Fed) led Congress to strike a deal in which the Fed obtained a mandate to push for international agreement on minimum capital adequacy standards.[24]

The US authorities set out to convince their BCBS counterparts of the need for an international agreement on capital adequacy standards, but met with a lukewarm response. This led the US to continue bilateral negotiations with the UK, since the Bank of England (BoE) had shown a willingness to negotiate an agreement. The US-UK agreement consisted of a risk-weighted capital standard with two tiers of capital and would govern the two single largest global financial centres (London and New York).

The potential threat of being excluded from these centres brought Japan, as the third banking superpower, to the table. After negotiations on what was to be included in the definition of capital, this resulted in a trilateral agreement mostly on similar lines as the US-UK agreement. These developments served as a strong incentive for the other members of the G10 to overcome their initial reluctance to come to a multilateral agreement, so as to at least be able to influence the final accord.[25] The US-UK agreement laid the foundation for subsequent negotiations, with the different other countries seeking measures to accommodate specific issues relevant to their domestic banking constituency.[26] The G10 banking supervisors reached a multilateral accord by the end of 1987, on which national authorities subsequently invited comments from their domestic banking sector.

In July 1988, the members of the BCBS came to a final agreement.[27] This Basel I Capital Accord had two main aims: (1) ensuring the safety and soundness of banks, and (2) levelling the international competitive playing field. It was a risk-weighted capital adequacy standard that requires banks to hold 8 per cent of capital against outstanding risk-weighted assets. Risk weights are assigned according to asset class, with five different classes. A fundamental shift in the pattern of governance had taken place from the national level to this first-time international agreement regarding bank capital adequacy standards; as a result the international terms of competition were effectively refashioned.

The Basel I Accord had different impacts on the market structure through changing the terms of competition between banks, as well as by influencing the demand and supply side. Due to the different risk weightings for different asset classes used in this new pattern of governance, the incentive structure for the allocation of bank capital changed considerably. The Accord provided incentives for banks to move into business that would not increase their

[24] Oatley & Nabors, 1998.
[25] Wood, 2005, p. 74 - 81.
[26] See for example Underhill, 1997, p. 30.
[27] The first Accord can be found on the BIS website, but note that this version has been subject to alterations in light of subsequent policy discussions.

risk-weighted capital reserves. Government securities of OECD countries became, for example, more attractive (since they had a 0 per cent risk weight), while foreign currency loans to non-OECD countries became less attractive (given that these had a 100 per cent risk weight). Also, so-called off-balance sheet activities like derivatives trading became more interesting. This fuelled a proliferation of complex financial instruments. Within each asset class, banks would have the incentive to seek the highest yield (and thus the most risky assets within the class).

Furthermore, the Capital Accord is credited with strengthening the consolidation trend in the global banking industry.[28] Consolidation provides economies of scale in risk management departments, allowing further specialisation and sophistication. At the same time, competition from nonbank financial institutions increased because these did not bear the regulatory burden of Basel I. A final impact on the market structure was the acceleration of the internationalisation of the banking market throughout the 1990s (in line with the stated aim of levelling the international playing field).

The aforementioned changes in the market structure also led to new preferences of main actors with respect to capital adequacy standards. The large, internationalised banks with complex risk management strategies found the Basel I regulations increasingly constraining. They considered their own approaches to risk management superior to the Basel I rules, and increasingly began to push for a renegotiation of the Basel I Capital Accord. Banking supervisors in turn recognised the perverse effects of the Accord (greater risk taking).[29] The changes in market structure as a result of Basel I led to a simultaneous shift in governance: in 1996 the Accord was significantly augmented by the market risk amendment. But the pressures of changing preferences and convergence of views between private actors and supervisors continued and culminated in the publication by the BCBS of a first consultative paper for a new Capital Adequacy framework in June 1999.[30]

This new phase in the policymaking process produced a simultaneous and significant change in the process: the negotiations on Basel II were a much more collaborative process driven by the BCBS Secretariat. It was no longer the US representatives pushing the Accord; the policymaking process was by now firmly institutionalised in the BCBS. During the negotiations on the Basel II Capital Accord, the BCBS Secretariat managed a formal 'open' consultancy process. These formal consultations allowed interest groups to petition the BCBS directly, as opposed to during the Basel I negotiations when the main route of lobbying consisted of banks approaching their home governments.

During the policymaking process and consultative rounds the debates centred on a number of topics. The most important topic was the use of ratings and internal risk management models (reflecting the comprehensiveness supervisors preferred and flexibility banks desired). Supervisors

[28] Llewellyn, 1989, p. 46, paraphrased in Wood, 2005, p. 90. Groeneveld, 1999 inter alia also points to the influence of international harmonisation of regulation.

[29] Jackson et al., 1999.

[30] BCBS, June 1999.

sought to elaborate a comprehensive approach to addressing risk, partially in response to the market development of bigger and more diversified institutions. This was mainly reflected in the debate on a second topic: the issue of operational risk. A third topic was the treatment of different national idiosyncrasies (which also concerns the effects of the Accord on bank lending to developing countries).

Especially the first and second issues reflected an interesting trend: although operational risk increased the scope of the Accord (adding regulation for banks), the use of internal models shifted an important part of supervision to banks themselves, highlighting a trend towards more market-based supervision. However, this trend also increased the complexity of the Accord and thus the difficulty of coming to an agreement. The Accord was finished four years after the initial deadline, following protracted consultations and negotiations.

The G10 central bank governors approved the Basel II Accord in June 2004. The Accord consists of three pillars. The first pillar sets minimum capital requirements and allows banks to use their own internal risk models (the most important preference of the large internationalised banks). The second pillar provides for continued dialogue between supervisors and banks in order to deal with the idiosyncrasies of individual banks and establish parameters for the internal models (strengthening the position of banks in the policymaking process). The third pillar enhances bank transparency with the intent of exposing banks to the discipline of the market. Both the first and third pillars signify a shift towards a more market-based governance pattern. The implementation in different G10 countries, especially the US, proved to be more difficult than originally envisaged. With the Accord only (fully) implemented in a few countries, the process was overtaken (and derailed) by the 2007 global financial crisis.

As this brief discussion of the case shows, there is a relationship between shifting patterns of governance and changing market structures, with the policymaking process as an important go-between. This means the case allows for an analysis of a series of simultaneous shifts in the patterns of governance and changing market structures over time. The relationship between these shifts is the empirical and analytical focus of this case study and the thesis as a whole. Furthermore, the case shows how state agencies deal with market pressures and interact with international counterparts from the public and private sector. This sheds light on the question of the role of the state in a globalising financial system.

The current financial crisis has underscored the importance of this case study: the renegotiation of the Accord (even though it was not yet fully implemented) to what is already called a Basel III Accord was one of the key policy responses to the crisis.[31] This seems to have the potential to lead to a new shake-up of the banking market. The most important topics in these negotiations are a better modelling of the risks of securitisation, a stricter definition of what may count as capital for banks, the obligation for banks to raise capital buffers when times are good and higher capital adequacy requirements for systemically important banks.

[31] See the discussion in the Conclusion.

In addition a second, simpler measure for capital adequacy is proposed: a gearing ratio (a ratio of capital to balance sheet total). Again, this seems to indicate a relationship between changing market structures (in this case in the form of a crisis) and shifting patterns of governance (with the aim of creating a governance pattern that is able to mitigate the risks of similar crises emerging in the future). The effects of the crisis and the negotiations on Basel III will be further discussed in the concluding chapter.

Sovereign debt crisis resolution for emerging markets

The second case study concerns the governance of sovereign debt crisis resolution. Where the previous case involved governance aimed at crisis prevention, this case involves sovereign debt crisis management (the debtor has repayment problems and default may be on the horizon or has already occurred). In addition to the scholarly relevance of this case, it is also worth noting the societal costs of sovereign debt crises (and hence the societal relevance of finding a governance pattern to mitigate these). The 2001 Argentinean debt crisis, for example, led to a cumulative loss of output of 20 per cent and a marked increase in poverty.[32] Capital mobility allowed states to increase their foreign funding, while increasing the risk of sovereign debt crises. Debt crises are often preceded by a currency crisis, which also shows how sovereign debt crises are intimately linked to cross-border financial integration.[33] Below, the political trade-offs involved in resolving sovereign debt crises are discussed first. Subsequently the developments within this policy domain since the 1980s will be outlined. This works towards showing the relevance of this case with respect to the research questions.

The balancing act of sovereign debt crisis resolution

When extending credit, there is always the risk that the debtor will be unable or unwilling to repay the debts. This poses costs for creditors, which in the case of private debtors are usually not only financial intermediaries but also (former) employees and the state (receivable taxes). Where in the distant past insolvent debtors could be thrown into jail until payment was made, nowadays a governance pattern for resolving such insolvency has emerged in the form of bankruptcy laws. These laws aim to minimise and distribute the costs of insolvency for the parties involved. In the case of companies, this often means attempts to keep the business in operation as it is more valuable when 'in business' than liquidated (i.e. the assets of the company are sold and it ceases to exist as a legal entity). This even means new credits can be extended for daily operating expenditures, as long as this improves the long-term capacity to repay the creditors (so-called debtor-in-possession financing). A public authority in the form of a bankruptcy court implements this governance pattern.[34]

When the debtor is a state, however, the situation is more complicated as sovereign states cannot be liquidated.[35] Moreover, it is difficult to determine the assets and payment capacity of states. This capacity is dependent on future economic growth, which is not only hard to predict but also to a large extent determined by developments in the private sector that might be beyond the control of the government that has incurred the debt. It is therefore difficult to determine whether a sovereign debt crisis is a temporary phenomenon (a liquidity crisis) or a structural phenomenon (a solvency crisis).[36]

As it is not possible to 'liquidate' a state, in practice there are three elements to resolving a sovereign debt crisis: official refinancing, domestic adjustments increasing the capacity to repay, and restructuring of (private or public) creditor debts.[37] To start with the latter, creditors may accept that debtor repayments will be postponed or reduced. This basically resembles private sector refinancing, as nowadays most sovereign credit is provided by private actors. Second, the state may implement economic reforms improving its capacity to repay. Strictly speaking this can be done by improving growth prospects, but also by improving fiscal balances (either by budget cuts or by improving the ability of the state to extract taxes from the economy). The first-mentioned element above (official refinancing) is new financing that is used for debt repayment. In the current international financial architecture the IMF is the main international organisation providing such financing in case of crises, with the World Bank and regional development banks providing long-term structural finance. This new financing of course only works towards improving the financial situation of the debtor state if it reduces the repayment burden, for example because of lower interest rates.

From an economic perspective, (sovereign) debt crisis resolution requires coordination via governance as it suffers from collective action problems and self-fulfilling crises.[38] In sovereign debt crises individual rational action does not lead to collectively optimal outcomes. Although it might be best for the group of creditors to accept a (limited) reduction in the value of their bonds instead of forcing the country into full default, each individual creditor has an incentive not to accept the reduction of value of his/her claim and let other creditors carry the burden. The notorious case of Elliot Associates (which was popularly dubbed 'vulture fund' or 'rogue creditor') versus Peru underscored this collective action problem.[39] This collective action problem becomes increasingly difficult the more creditors are involved, making club-like solutions based

[32] Roubini & Setzer, 2004, p. 27 (footnote 4). See Blustein, 2005 for a well-informed journalistic account of the Argentinean crisis.

[33] Rieffel, 2003, p. 17.

[34] See Balleisen, 2001 for an interesting account of the role of bankruptcy regimes in the emergence of modern societies.

[35] Historically, some creditor nations sent gunboats to collect their debts (Herman, Ocampo & Spiegel, 2010, p. 5 and footnote 7). Arguably conquering a debtor state is about as close to liquidating a state as one can get.

[36] The same problem might emerge in the banking sector. An illiquid bank might be saved by a central bank liquidity injection, without social costs. When the bank is insolvent, on the other hand, state support would socialise the costs of bankruptcy. It is doubtful, though, whether this analytical distinction is meaningful in practice; see Diamond & Rajan, 2005.

[37] Roubini & Setzer, 2004.

[38] Rogoff & Zettelmeyer, 2002.

[39] See also Thompson & Runciman, 2006.

on moral suasion no longer feasible. It can be solved by a statutory mechanism (like a bankruptcy court) or a contractual solution installing majority decision-making among creditors (Collective Action Clauses, CACs). With the advent of capital market financing, the sovereign debt markets became vulnerable to a situation comparable to a bank run: if all creditors withdraw at the same time due to a sudden shift in confidence in the nation's ability to pay, a nation actually does face a debt crisis (as it cannot refinance payments becoming due).

The three means of resolving sovereign debt crises mentioned above correspond to the main actors involved: creditor states and official sector representatives like the IMF and Multilateral Development Banks (MDBs), debtor states, and private creditors. Some sort of balance needs to be struck between the preferences of these three sets of actors to resolve a sovereign debt crisis. In theory, this balance can also mean putting the burden solely on one of the actors. In practice, however, it often comes down to an IMF programme (official refinancing) with conditionality attached. Under the conditionality, the recipient state agrees to implement domestic reforms. Access to new private financing is assumed to be restored by the IMF programme and sometimes additional private debt restructuring programmes are also implemented.

The issue of burden sharing among the three parties (the debtor state through economic reforms, the private creditors through restructuring, or the official sector through refinancing) and the trade-offs among the actors involved makes finding the balance politically charged. In other words, it determines not so much who gets what, when and how; but who pays what, when and how. It is this question that lies at the heart of the political economy of sovereign debt crises, and which is the focus of this case study. For example, a bigger reduction in obligations to private creditors[40]) would lead to less need for official refinancing or economic hardship for citizens in debtor states. Discussions on who is to blame for a debt crisis (fiscal mismanagement of the debtor state or imprudent lending by the capital markets) flow into a determination of who should legitimately pay for the fallout from the crisis.

As a technical, economic exercise, this would already be difficult enough. First of all, a prediction of the future financing gap is needed to assess the countries' ability to repay debts. This is dependent on future economic growth and the prospects for regaining market access. Both these elements are difficult to predict and the IMF has been consistently off the mark in attempting such predictions.[41] Next to this difficulty, the question arises which discount rate to use. The choice of discount rate is important to calculate the Net Present Value (NPV) of future payments and thereby influences (the perception of) the 'haircut' private creditors have to endure. Higher discount rates reduce the NPV of claims and therefore make the restructuring appear more punitive for private creditors.[42] This second 'technical' issue already hints at the politics involved in finding the right balance between the three elements: the choice of discount rate influences the assessment by different parties of what the right balance is. Moreover, it is also a choice with a distributional impact.

Next to the 'technical' accounting matters, which turn out to have political underpinnings, the bigger political question concerns the burden sharing between the different parties involved in the debt crisis. The regulations constraining actors in the negotiations on this 'big' question of debt crises are the focus of this case study. The balance found between the three elements determines the burden each actor bears for solving the debt crisis (as mentioned above). This draws our attention to mechanisms for facilitating the negotiations between debtors and creditors, but also to mechanisms of applying 'conditionality' to debtor states. There has been a continuing search for a governance pattern that would ease the detrimental consequences of sovereign debt crises on societies and reduce economic costs through an orderly and equitable resolution process. Below, the developments in this policy domain over the period of study are sketched in broad strokes.

How did sovereign debt crisis resolution develop: from Baker/Brady to CACs and Principles

Similar to the discussion of the bank capital adequacy standards case above, the developments in this case are for the sake of exposition discussed in three phases: first of all the policy responses to the Latin American debt crisis of the 1980s; secondly the changes in market structure in response to the Latin American debt crisis and its resolution; and thirdly the emergence of demands for new mechanisms for sovereign debt crisis resolution in the wake of the multiple emerging market financial crises of the second half of the 1990s and the conclusion of that phase of the policymaking process with the agreements on Collective Action Clauses and the 'Principles for Stable Capital Flows' (and the failure of the proposal for a Sovereign Debt Restructuring Mechanism, SDRM). As these developments show, there is significant and symbiotic variance over time in the governance pattern in relation to the market structure for the provision of sovereign credit.

As mentioned above, the IMF is the main provider of official financing in crises. The IMF's Executive Board and its International Monetary and Financial Committee (IMFC) are therefore the prime global level policymaking institutions in this case. The rapid internationalisation of the financial system after the fall of the Bretton Woods system in the early 1970s greatly expanded the possibilities for middle-income countries to gain access to private credit. This led to a gradual expansion of the share of bank loans in the debt stocks of middle-income countries. These loans were put together by syndicates of banks, often involving dozens of banks worldwide. In the early 1980s, a global recession, rising real interest rates and declining terms of trade for debtor economies combined to produce repayment difficulties for the debtor countries, mainly those in Latin America.[43] This Latin American debt crisis endangered the global financial system as it threatened the solvency of banks all over the Western world.

[40] 'Haircuts' in bond market vernacular, referring to a reduction in the Net Present Value of debts.
[41] See De Jong & Van der Veer, 2010 for an assessment of the success in predicting financing gaps.
[42] See Kozack, 2005 for an analysis of the implications of using different discount rates.
[43] Oliveri, 1992, chapter 2.

Given this situation, it is not surprising that in the ensuing policymaking process protection of the solvency of Western banks was an important concern. With US banks the most exposed, US authorities took the lead. This tilted the balance towards domestic adjustment in the debtor states combined with official refinancing. Debtor states embarked on IMF programmes (with increasingly stringent conditionality attached) in combination with co-financing of the private sector. This approach was in line with the preferences of the majority of the banking community.[44] So even though the public sector took the lead, the preferences of the creditor states were closely aligned with their private sectors' preferences. The preferences of citizens in the debtor states were relatively unimportant in the process, reflected in the high burden of adjustment.

By the mid-1980s, the effects of this initial round of IMF packages with private sector co-financing began to wear off, and there was insufficient economic growth to secure repayment of IMF loans. This led to the Baker plan (named after US Secretary of the Treasury James Baker).[45] The Baker plan acknowledged the fact that growth in the debtor countries would have to be increased before they would be able to fully repay their debts. The methods of the Baker plan were very much like the earlier procedures dealing with the crisis on a case-by-case basis, although with more emphasis on long-term rescheduling of debts through Multi-Year Rescheduling Agreements (MYRAs) and renewing capital inflows (through a greater involvement of the World Bank and regional MDBs). The private sector in the meantime continued to reduce its exposure to the debtor states. The ad hoc response of the Baker plan was strongly endorsed by the G7. However, it was ultimately also unsuccessful in restoring growth in Latin America, and in the beginning of 1987 Brazil declared a moratorium on interest payments.[46]

In response to the rising tension on the debt issue, the US government once again took the lead. This time the new US Secretary of the Treasury Nicholas Brady drafted a plan shifting the balance from domestic adjustment to debt forgiveness from the private sector and increasing official financing. The debt forgiveness under the Brady plan was based on voluntary, market-based approaches. It used public sector funding to collateralise new bonds, which would include private sector debt reduction (so-called Brady bonds). The IMF was allowed to lend into arrears (under its Lending-into-Arrears, or LiA policy), increasing debtor state leverage vis-à-vis private creditors.

As a (temporary) pattern of governance the Brady plan had an important effect on the growth of the bond market for emerging market sovereign debt through the securitisation of their debts. Middle-income countries increasingly began to source their private credits directly from the capital markets by emitting international bonds. The banks, still struggling with the outstanding debts, made the strategic choice to act as intermediaries of sovereign

44 Bergsten, Cline & Williamson, 1985, p. 22.
45 Cline, 1995, p. 207/208.
46 Shepherd, 1994, 309.

debts rather than to act as end holders of debts.[47] This development diversified the creditor base of countries, and complicated the coordination between creditors in a possible sovereign debt crisis (as became abundantly clear during the 1994/1995 Mexican crisis).

With the Brady plan successful in neutralising the risks of further repayment problems for Western banks, complacency seemed to set in among policymakers while the market structure continued to change in response to the Brady plan. The collapse of Mexico in 1994/1995 served to give a new impetus to the policymaking process. In response, the G7 commissioned the G10 to draft a report on the orderly resolution of crises. Shortly after that, a further crucial impetus was provided by the 1997/1998 East Asian crisis. Two main alternatives were on the table during the discussions: a formal Sovereign Debt Restructuring Mechanism and Collective Action Clauses for bonds. These two proposals are not incompatible, but do involve quite different shifts in governance: a global level 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' (CoGC) for relations between debtors and creditors, resulting in the 'Principles for Stable Capital Flows'. These were developed by the private sector led by the Institute of International Finance (IIF) in cooperation with leading debtor countries.

The SDRM was proposed by the IMF and offered a comprehensive and intellectually rigorous solution to the new capital market-based market structure. To simplify the resolution of sovereign debt crises an independent 'court' (comparable to national bankruptcy procedures) would rule on a stay in payments until the debtor country and its creditors had agreed on a balance between domestic adjustment and private restructuring (it was initially unclear how IMF financing would figure in the balance). It would cover all outstanding claims of a country and subject them to an integrated restructuring.

CACs, on the other hand, most importantly 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), it is binding for the whole outstanding bond. CACs are a market-based and voluntary solution, in the sense that they require negotiations between the debtor state and private creditors as market actors without the presence of a 'higher authority' like the SDRM. The 'Principles' also seek to facilitate negotiations between debtors and creditors during (and before) debt crises.

The policymaking process culminated in the 2003 IMF Spring Meeting. Lobbying activity by the private sector in the run-up to this meeting increased in intensity. Emerging market governments, fearing private sector capital flight, embraced the CACs as an alternative to the SDRM. In an effort to weaken the case for the SDRM, Mexico emitted the first international bond under New York law with CACs. Given the opposition from different sides

47 De Carmoy, 1987, p. 15. This development was further spurred by the Basel Accord giving a 100 per cent risk weight to non-OECD sovereign debt; see also the case study description above.

and faltering support, the SDRM proposal was shelved by the IMF Board of Governors. The market-based CACs in combination with the Principles were to be the only substantial change in the governance of sovereign debt crises.

As this brief description shows, the policymaking process in this case exhibits interesting interaction between public and private actors in different coalitions, changing over time with the changes in market structures. The peculiar position of states in this debate (as debtor and as designer of the governance pattern) provides an interesting additional perspective to the previous case. The dynamics between state debtors and private creditors makes this a case well-suited to understanding the dynamics of the global financial system both in terms of governance and in terms of market structure. It allows for a better understanding of the relation between public and private actors, since specifically the public actors have a different role than in the bank capital adequacy standards case. As with the bank capital adequacy standards, this case also shows how states try to cope with globally integrated financial markets by building a 'global financial architecture' of which a governance pattern for sovereign debt crises is an important element.

With the solvency of the so-called PIGS in doubt as a result of the current crisis (as reflected in market spreads and combined EU/IMF rescue packages), attention to the governance pattern of sovereign debt restructurings has returned. Policymakers noted that there was still no mechanism for the orderly resolution of sovereign debts, even in the context of a formal monetary union. CACs do not apply to the existing debt stock of EU member states, and in any case only apply to the bonds of states which are subject to foreign law. The governance pattern for sovereign debt crises is back on the agenda, which is all the more reason why it is important to understand what happened during previous phases in the policymaking process.

Main argument

The introduction of the cases above points to a number of principal arguments that will be elaborated in the remainder of this thesis. First of all, for both cases, the changes in market structure ('globalisation of the financial system', reflected in bigger, international banks and increased capital market financing of emerging markets) seem to have shifted the preferences of actors and led to the emergence of global-level public policymaking institutions in which private actors are highly involved. These developments facilitated the shift from 'public' governance at the international level (the governance patterns of Basel I and the Baker/Brady plans) to greater private sector self-regulation at the global level (the governance patterns of Basel II and the CACs plus Principles). This demonstrates that policy outcomes cannot be explained through state-centric approaches[48], but that internationally active private

[48]E.g. Kapstein, 1994.

actors and the nature of their relationships to crucial state agencies need to be included in the equation. At the same time it demonstrates that the simultaneous globalisation of the financial system and the development of new forms of multilevel governance is not an exogenous development.

Furthermore, in both cases there is a dynamic whereby shifting patterns of governance lead to changes in market structures and vice versa. Basel I contributed to the emergence of diversified and international banks with sophisticated risk management practices. This shifted private actor preferences towards the use of in-house risk management models. Public actors followed this preference as they witnessed that this new market structure allowed for the 'gaming' of Basel I with the associated increases in risks. These shifting preferences led to the renegotiation of Basel I to Basel II. In the case of sovereign debt crisis resolution, the Brady plan encouraged capital market financing of emerging markets. This diversified the preferences of private actors and led to a reduced sense of urgency to make progress on this issue. At the same time, public actors (specifically the IMF) acknowledged the potential risks and therefore proposed a comprehensive approach. This was defeated by the influence of private actors in the policymaking process and the lack of support among debtor states, which feared their market access would be hampered by private sector responses.

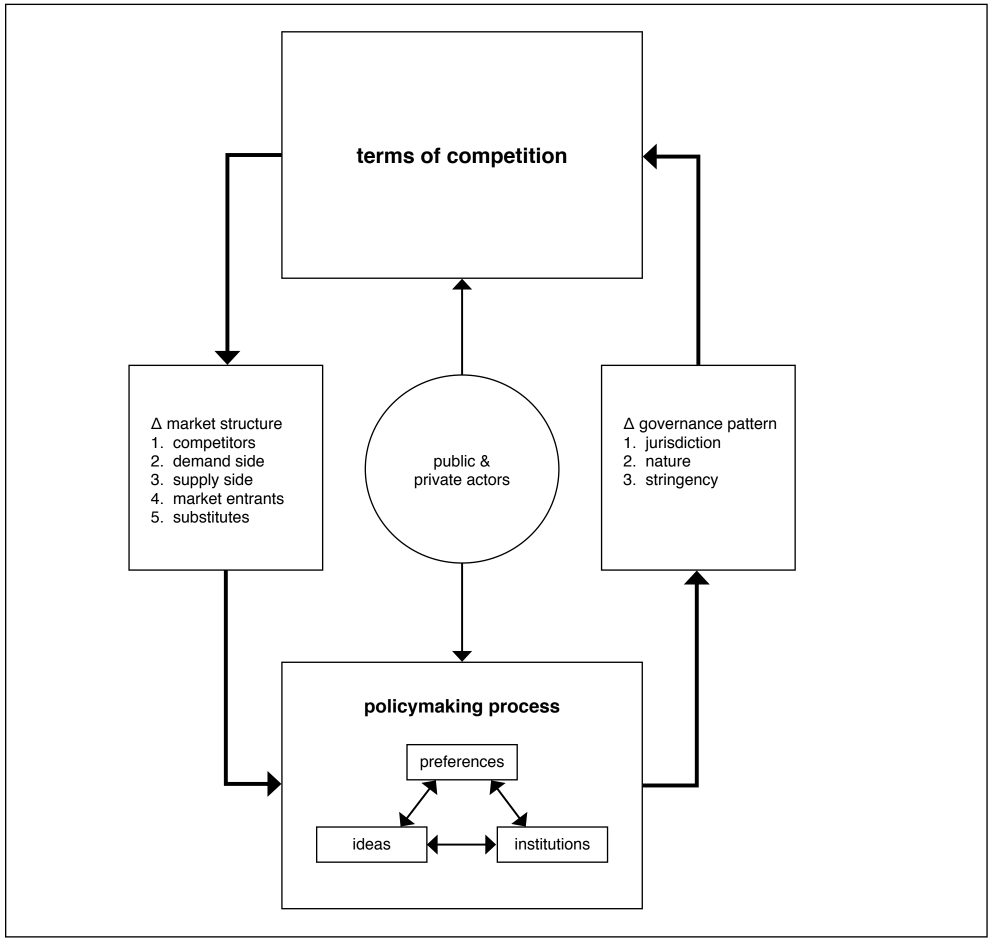
Both cases also show that public actors played an important role every step of the way. Their preferences reflected both a 'theoretical' understanding of how markets should function and their own market position (e.g. on the demand side of sovereign credit). As such, public actor preferences can counterbalance or complement private actor preferences which are sometimes more narrowly self-interested (e.g. the operational risk issue in the Basel Capital Accord or the emergence of a standard for CACs). This leads to the argument that the 'retreat of the state' debate misses the actual point, as this research will show that it is the collusion of public and private actors that is driving this process.[49] There is hence no retreat of the state; at best there is a shift in the power balance between different state agencies (e.g. ministries of finance involved in the global policymaking institutions versus the nationally oriented ministries of social affairs).

This preliminary analysis of the cases points to the relevance of the approach taken in this thesis, which can be summarised in two core arguments. First, at the most general level, it is argued that there is a symbiotic relationship between the changing structure of the market and shifting patterns of governance: changes in the terms of competition lead to changing market structures which generate changes in actor preferences concerning regulation and governance, and the outcome of conflict over divergent actor preferences concerning governance and regulation (the shifts in governance pattern) generates new terms of competition and so forth. Changes in preferences concerning governance therefore appear intimately intertwined with preferences concerning the terms of competition. This feedback loop is shown

[49] This contradicts analyses which see for example the shifts in governance regarding sovereign debt crisis resolution solely driven by private interests (Soederberg, 2005). For a similar approach to earlier developments in global financial governance see e.g. Helleiner, 1994.

schematically in figure 1.1 below.

Figure 1.1 The interaction between governance pattern and market structure.



The second argument underpinning the approach of this thesis states that public actors continue to wield crucial influence on the dynamics of the global financial system, even in the face of the huge growth of financial markets and its cross-border and cross-sector integration. Both public and private actors have an interest in global financial stability, and public actors are crucial in overcoming the collective action problems to achieve this. Furthermore, public actors have an important influence in the global financial system through their role as market players (e.g. on the demand side of sovereign credit). The debate on states in globalised markets seems to be misguided by its implicit state-market dichotomy. An integrated notion of changes in market structures and shifting patterns of governance points to the interaction

between public and private actors as the main force behind change. The preferences of public actors in this interaction are linked to their position in the policymaking process and their role as market actor. They hence develop their own position related to their position in the market. Although the policymaking institutions might change, the continuing importance of (certain) public actors in producing authoritative decisions regarding governance patterns does not.

Summary and thesis structure

To sum up, each case study in its own right contributes to answering the research questions of this thesis and hence to an improved understanding of the dynamics of the global financial system. The policy domains of both cases demonstrate how a similar set of public and private actors constantly interact, both on markets and in the policymaking processes. This will consequently enhance our understanding of the relation between states and markets. Importantly, there is variation both within and between the cases: one saw the successful adjustment of a global level Accord, while the other saw the defeat of a proposal for a global public institution resolving sovereign debt crises.

Next to the analytical purpose and value of these two cases, the discussion above also showed that both case studies have important societal relevance. Both policy domains feature prominently in the policy debate that emerged in response to the current financial crisis. Explaining the policymaking process in previous renditions of this debate could be a valuable tool in pushing the discussion forward in the right direction this time.

The remaining chapters of this thesis will follow a rather standard course in response to the research questions. In the following theoretical chapter, the concept of governance is first clarified so as to understand the different dimensions of the shifts in governance that have been discussed above. Secondly, the theoretical approach of this study is presented. The chapter elaborates how we can theoretically explain the relationship between market structures and patterns of governance through the policymaking process. This approach overcomes the state-market dichotomy (implicitly) assumed by too much of the literature and creates a feedback loop between changes in market structures and shifting patterns of governance. This feedback loop is positioned in contrast to other theoretical approaches mainly stemming from the Economics and Political Science literature with respect to state-market relations, financial governance and the policymaking process. Furthermore, this chapter will also present a discussion of the methodological issues relevant to this thesis. Finally, it will provide an elaboration of the arguments which will be advanced.

The third chapter serves to 'set the stage' for the application of the theoretical approach in the two case studies. In this chapter the historical context of the present study is presented, showing how the changes in the market structure under Bretton Woods (notably the rise of the Euromarkets) shifted the preferences of public and private actors and led to the abolition of the Bretton Woods governance pattern. The chapter furthermore provides an elaboration on the role and functioning of the main actors and institutions as they emerged and developed over the period of the cases. This is set against the background of a trend of financial integration and expansion that continued over the period of our case studies. As such, the chapter provides the background to the arguments developed in this thesis.

The fourth chapter deals with the first case study of bank capital adequacy standards. It traces the changes in governance (from the Basel I Capital Accord to the Basel II Capital Accord) and the accompanying changes in the market structure (mainly consolidation and internationalisation and the accompanying change in business models). The chapter will highlight the relation between the two by showing the impact of Basel I on the banking market, as well as how the subsequent changes in the market structure also led to shifting preferences for governance. These shifts stimulated the renegotiation of Basel I. The chapter offers an explanation for the shifts in governance from Basel I to Basel II in the exclusionary policymaking institutions that result in private sector preferences that exert a strong influence on the policymaking process. These exclusionary, club-like policymaking institutions also lead to groupthink favouring financial sector interests.

In the fifth chapter, the sovereign debt crisis resolution case study is analysed showing developments from the Latin American debt crisis to the policy proposals in the wake of the East Asian crisis of the late 1990s. This shows how the governance pattern developed after the Latin American debt crisis – which was focused on public actors - failed to address the challenges that the growth and diversification (in the sense of increasing private capital market funding) of the market for sovereign debt posed. After the East Asian crisis, important proposals countering the 'laissez-faire' governance pattern of the late 1990s were put on the table, but defeated by a successful lobby of market actors (both creditors and debtors).

In the final chapter the argument will be summarised and conclusions will be drawn. The chapter will illustrate the contribution of the theoretical approach used in this thesis, but will also identify some challenges for future research. Also, the implications of the current crisis for the arguments put forward in this thesis will be discussed by providing an 'update' of the case studies. In other words, the policymaking processes of Basel III and the resolution of the sovereign debt crisis in the Eurozone are tentatively analysed. Finally, the concluding chapter will discuss the implications of the research for both IPE and society at large.

Chapter 2

Theorising the global financial system: governance, market structure and the policymaking process

In this chapter, the theoretical approach that will be used to analyse the dynamics of the global financial system in the two policy domains of this study is developed. As the opening anecdote of the Introduction made clear, at the time of writing a global financial crisis is having a significant impact on the financial system and – more importantly – the socio-economic prospects of millions of people. Notwithstanding the urgency and uniqueness of the current crisis, it can be noted that the development of financial systems has historically always been accompanied by financial crises. As has been abundantly documented empirically[1] as well as modelled theoretically:[2] financial markets are not stable. However, the severity and (global) contagion effects of financial crises may vary depending on the prevailing market structure in financial markets, as the likelihood of prevention, containment and efficient resolution of crises is closely related to the governance pattern of the financial system.

With the fall of the Bretton Woods system of governance, the internationalisation of financial markets accelerated. However, this also implied that, for example, banking crises had important cross-border repercussions (underscored by the Herstatt Bank failure).[3] National level patterns of governance and domestic authorities were faced with international linkages created by global financial market integration, and were consequently no longer able to deal with financial crises single-handedly. However, while financial firms were allowed to compete on a global scale, crucial aspects of the governance pattern seemingly 'lagged behind' in important respects, increasing the potential mayhem financial crises could cause.

Given the known likelihood of financial instability – and its detrimental consequences – it is puzzling that a pattern of financial governance that mitigates the worst financial instability ex ante has not emerged. A related puzzle concerns the relation between global market integration and governance. While there are many theories of shifting patterns of governance, none seems to be able to satisfactorily explain why it is that some aspects of governance apparently 'follow the market' and shift to the global level while others remain national, especially

[1] Bordo et al., 2001; Kindleberger & Aliber, 2005; Reinhart & Rogoff, 2009.
[2] E.g. Minsky, 1982.
[3] These developments will be elaborated in the next chapter, which provides the historical background to the case studies of this thesis.

when we look at the 'public' provision of governance.

These puzzles cut to some of the core issues in International Political Economy (IPE) such as the relation between states and markets, the interaction between different levels of analysis and the relation between public and private actors.[4] Furthermore, it links to an important debate in the literature concerning the role of states in globalising markets. Are state agencies receding in the face of the pressures of global financial markets, or is the state still the crucial institution in the governance of the global financial system?[5] Assembling some pieces of these puzzles will therefore contribute to a long tradition of thinking about the relationship between states and markets, and will demonstrate the value of IPE as an '(inter) discipline'[6] bridging debates in (Comparative) Political Science, International Economics and International Relations to come to a fuller understanding of the contemporary global political economy. An analysis of the dynamics of the global financial system can therefore be embedded in a rich diversity of cross-disciplinary literature on the political economy of finance, at both international and domestic levels of analysis.

In this chapter the two related puzzles are addressed, and in doing so a theoretical approach is developed that is suitable to address the central question of this thesis (what explains the relationship between market structures and patterns of governance). This central conceptual concern informing the thesis is addressed through three research questions, which were derived from the central question in the Introduction. Each of the research questions brings its own set of theoretical considerations, focusing on different bundles of literature. The main purpose of this chapter is to provide the theoretical groundwork for dealing with the research questions by embedding the analysis in these different bundles of literature. In integrating these literature debates – which each focus on part of the central conceptual concern – the chapter will work towards resolving the two puzzles.

The first research question (how has the pattern of governance shifted in the two policy domains of bank capital adequacy standards and sovereign debt crisis resolution over the period 1980 - 2005 and how have the relevant market structures changed over the same period) points to the importance of the concept of governance in this thesis: what do we understand governance to be, in relation to the understanding of market structure? As the discussions of the cases in the Introduction showed, there seem to be different dimensions to governance patterns and shifts across these dimensions may vary. A first conceptual goal of this chapter is thus to analytically elaborate and clarify the concept of governance. Similarly, it will be discussed how to conceptualize market structure. This will allow for an analysis of how the pattern of governance has changed in the policy domains of the cases.

A second theoretical issue follows from the research question concerning the characteristics of the policymaking process leading to these shifts in the pattern of governance. This issue speaks to a bundle of literature dealing with political processes that produce specific patterns of governance. This extensive bundle of literature cuts across the disciplines of Economics, (I)PE, Political Science and Sociology. This literature provides useful building blocks (summarised as ideas, institutions and interests) to achieve the second conceptual goal of this chapter: to come to an understanding of the political process leading to shifts in governance through addressing these building blocks and the links between them.

A third theoretical issue bridges the previous two by dealing with the relationship between the policymaking process, its outcomes in the form of shifting patterns of governance, and how this relates to changing market structures. This debate addresses the third research question (the relation between shifting patterns of governance and changes in market structure) and links back to the general theoretical notion of the state-market relationship. The third conceptual goal of this chapter is therefore to build a theoretical 'model' of the mutually constitutive relationship of governance and market structure.

These theoretical issues will be elaborated below, and together work towards a simultaneous explanation of governance patterns and market structures by means of a feedback loop. This feedback loop derives from an analysis of the policymaking process that focuses on the interaction between preferences (interests), ideas and policymaking institutions. The shifts in governance that are the outcome of this process lead to new incentives and constraints for market actors ('terms of competition'), and hence to changing market structures. These changing market structures lead to new preferences of both public and private actors with regard to governance patterns, which feed back into the policymaking process. Bringing the different sets of literature together in this manner will lead to a number of propositions, which will conclude the theoretical discussion.

The approach posited above and elaborated in the remainder of this chapter makes two – related – contributions to the literature. First, a focus on either market actors and market behaviour on the one hand, or on governments (states) on the other hand is overcome by understanding the dynamics of the global financial system through the simultaneous interaction between public and private actors in markets and policymaking processes. The policymaking process functions as the conduit between changing market structures and shifting patterns of governance, creating a feedback loop. It will be argued that this innovative approach contributes to a better understanding the dynamics of the global financial system, and - more generally - also of complex political-economic phenomena such as globalisation or economic development processes.

Second, and related to the first, this integrated account will provide new insights into the role of the state (public actors) in globalising markets. It allows us to gain insights into the way state agencies adapt to the pressures of globalisation. The feedback loop proposed here prevents us from seeing shifting patterns of governance as a one-way retreat of the state in the face of global markets. The intended and unintended consequences of this feedback loop provide space for state actors to exert agency. This contributes to a better understanding and

[4] Krätke & Underhill, 2006.
[5] For the former side of this debate, see, for example, Strange, 1996; for the latter Weiss, 1998 and Cerny, 2005.
[6] Underhill, 2000.

more nuanced position on the circumstances under which states adapt to the pressures of globalisation.

The set-up of this chapter is as follows: The first section discusses the emergence of the concept of governance, and positions the conceptualisation of governance used in this thesis in the literature. Furthermore, to clarify this broad concept, three dimensions of governance will be distinguished at the analytical level: (i) the level of jurisdiction to which the governance pattern applies, (ii) the nature of the authority involved in governing and (iii) the stringency of the governance pattern.

The second and third sections turn to explanations of shifts in governance. In the second section, the contributions from institutional theories rooted in Sociology and Economics, respectively Historical Institutionalism (HI) and New Institutional Economics (NIE), are discussed. As the discussion will show, while these approaches make important contributions, their main drawback is that they predict stability instead of the change witnessed in the preliminary case descriptions of the previous chapter. HI and NIE lack an adequate explanation of the policymaking process leading to shifts in governance.

The third section therefore adds a model of the policymaking process to the two institutional approaches. It does so by discussing the building blocks characterising policymaking processes that emerge from the IPE literature. This body of literature offers preferences (interests), ideas and (policymaking) institutions as the main categories of explanatory factors for policymaking processes. It is argued that a proper account of the outcome of the policymaking process can only be given by coming to an integrated analysis of these three factors.

In the fourth section the framework comes full circle by linking the previous steps to changing market structures, thereby responding to the third set of theoretical considerations concerning the relationship between the policymaking process, its outcome in the form of shifting patterns of governance and how this relates to changing market structures. In this section it is also argued that such a theoretical approach, which bridges the various literatures discussed in this chapter, works towards simultaneously explaining changing market structures and shifting patterns in governance, and consequently also works towards understanding the dynamics of the global financial system.

After developing this theoretical model of the dynamics of the global financial system, the fifth section will relate the theoretical discussion to the arguments made in this thesis and the propositions that follow from the approach. A final section discusses methodological issues and is followed by a brief conclusion.

Conceptualising global financial governance

As mentioned in the Introduction, in this study governance refers to the rules and regulations shaping the behaviour of actors in the financial system. Importantly, this concerns

not only rules and regulations emanating from states but also those emanating from non-state actors. This fits with the case descriptions from the Introduction that highlighted the important role of private actors and different forms of authority in the governance of the financial market. Below, this section first elaborates the emergence of governance as a theoretical concept, showing how the notion has encouraged a rethinking of the variety of actors involved in the state-market relationship. Second, the concept of multilevel governance is introduced and analytically clarified by distinguishing three dimensions (jurisdictional level, nature and stringency) across which shifts in governance can be mapped.

The emergence of the concept of governance in relation to IPE

With the emergence of internationally integrated financial markets in the 1970s, scholars like Cohen, Gourevitch and Strange began to call for a more general study of the relationship between political authority and markets at the international level. They drew attention to the influence of the international dimension in governance and political economy in general, and can thereby be seen as founders of modern IPE.[7] Despite a variety of approaches, the focus was on the interaction between states and globalising markets. In the Comparative Political Science literature, a similar debate has been framed around the question of convergence of national varieties of capitalism. Comparative political scientists examined different varieties of capitalism and their patterns of governance of the financial system.[8] These studies took both market and government (state) variables into account, commonly identifying Anglo-Saxon market-based (financial) systems and Coordinated Market Economies, which often have bank-based financial systems.[9]

The advent of (financial) globalisation led to an interdisciplinary debate on the role of the state in relation to global markets. Susan Strange provocatively claimed that "the impersonal forces of world markets are now more powerful than the states to whom political authority over society and economy is supposed to belong. Where states were once masters of markets, now it is the markets which, on many crucial issues, are the masters of the governments of states."[10] Comparative political economists wondered whether "financial deregulation could be the string that unravels coordinated market economies."[11] On the other hand, scholars started to point to the capacity of states to adapt to globalisation and to the role of states as drivers of globalisation. In other words, the powerless state was a 'myth'.[12]

7 Strange, 1970 and 1976, Cohen, 1977 and Gourevitch, 1978. See also Cohen, 2008 for an intellectual history of IPE (which also provides an extended account of the founding scholars).
8 E.g. Zysman, 1983; Moran, 1986 and 1991.
9 Hall & Soskice, 2001. Market-based in this context refers to the fact that corporate financing in the Anglo-Saxon system is based on securities (stocks, bonds), which are easily tradable in secondary markets.
10 Strange, 1996, p. 4.
11 Hall & Soskice, 2001, p. 64.
12 As an important contribution claimed: Weiss, 1998.

Scholars started to unpack the relation between states and globalising markets to understand how the state would adapt, or under what circumstances we might see retreat or adaptation by the state.[13] Yet, in the debate the focus seems to have shifted away from the role of the state to such an extent that Schmidt recently called for "bringing the state back in yet again."[14] This thesis will contribute to this debate by advancing a theoretical understanding that overcomes the state-market dichotomy that is either implicitly or explicitly present in much of this literature. The approach builds specifically on the work of Underhill who introduced the state-market condominium as his conceptualisation of this point.[15]

Analytically separating the domains of states and markets (even if only implicitly) risks underappreciating the mutually constitutive relationship between the two and the power relations this implies, as will be discussed in more detail below. The approach taken here stands in the tradition of the classic analysis of the industrial revolution by Karl Polanyi that demonstrates how markets are actively constructed by states, and how well-functioning markets are necessarily institutionally embedded in patterns of authority promulgated by the state.[16] In other words, the structure of the market is embedded in patterns of governance.

Market structure will be conceptualised in this thesis based on the 'structural analysis' of Michael Porter.[17] In this conceptualisation five elements determine a market structure: (i) the rivalry among existing firms in the market; (ii) the bargaining power of buyers; (iii) the threat of new entrants to the market; (iv) the threat of substitutes emerging; and (v) the bargaining power of suppliers. These structural features of industries (markets) together "determine the strength of the competitive forces and hence industry profitability."[18] An analysis of the market structure consequently warrants an analysis of the main features of market participants (both on the supply and demand side), new entrants and potential substitutes. These different elements of the market structure cannot be separated from the domain of the state, as in the case of the market being opened up to new entrants through trade liberalisation, for example. As another example, in the case of sovereign credits the demand side (the actor requesting credit) is composed of state actors.

The concept of 'governance' is well suited to overcome (implicit) state-market divides, and could be seen as the modern conceptualisation of Polanyi's institutional embedding. The conceptualisation of governance used in this thesis will be elaborated in the next subsection.

[13] Garret, 1998; Burgoon 2001; Mosley, 2003; Busch, 2009.
[14] Schmidt, 2009. The 'yet again' refers to an earlier call for bringing the state back in by Evans et al., 1985.
[15] See Underhill, 2003 and 2007b.
[16] Polanyi, 2001 (1944).
[17] M. Porter, 1998 (especially chapter 1).
[18] M. Porter, 1998, p. 4.

Conceptualising multilevel governance

The concept of governance has been developed in a burgeoning, interdisciplinary body of literature, which emerged in the 1990s.[19] Van Kersbergen & van Waarden point out that the Online Contents catalogue of academic journals returned 24 hits on the term 'governance' in 1990 and 510 hits in 1999, rising to 603 in 2000.[20] While becoming a cottage industry, studies on governance ran the risk of going the same route as studies on globalisation: a concept turning into a catch-all phrase that functions as an intellectual buzzword.[21] Its wide usage has led to a situation where governance means a great variety of things to a great number of different scholars. Eurocrats talk about governance through the open method of coordination,[22] the World Bank talks about good governance as an underpinning of successful development[23] and International Relations scholars like Rosenau talk about governance without government.[24] When they do, however, they each refer to quite different developments in the global political economy. Therefore, this subsection will first clarify the conceptualisation of governance to be employed in this work, showing its added value and placing it in the context of the literature. Subsequently, the subsection will focus on global financial governance, and will distinguish three dimensions of governance: jurisdictional, nature and stringency.

Two strands of literature can be distinguished, which each focus on different elements of governance. On the one hand there are studies that focus mainly on the process of generating the rules and regulations shaping actors' behaviour, while on the other hand there are studies that focus on the characteristics and nature of the actual rules and regulations. This study bridges these two strands of literature by linking the policymaking process to shifts in the characteristics of governance.

The first strand of literature, focusing on the pattern of interaction of actors, primarily evolved out of the literature on policy networks and policy communities,[25] but also has a strong base in European Studies (e.g. studies on the open method of coordination or experimentalist governance).[26] The emphasis in this literature lies on the inclusion of new and diverse actors in the policymaking process, pointing to the importance of not only understanding the role played by public (governmental) actors in policymaking processes, but also of the role played by private and civil society actors.[27]

[19] For reviews of the literature, see Van Kersbergen & van Waarden, 2004; Brunnengraeber et al., 2006; and Treib et al., 2007.
[20] Van Kersbergen & van Waarden, 2004, p. 144.
[21] For a discussion and further references on this trend with the concept of globalisation, see Busch, 2009, p. 1 - 5.
[22] Based on Sabel & Zeitlin, 2010.
[23] World Bank, 1997.
[24] Rosenau, 1992.
[25] See, for example, Rhodes, 1997.
[26] See Zeitlin & Pochet, 2005.
[27] Treib et al., 2007, refer to this as their first category of governance conceptualisations, which is focused on politics. Their second and third categories are then based on, respectively, polity and policy and overlap more closely with the approaches to governance that focus on the rules and regulations (which will be discussed next).

The second strand focuses on the characteristics and nature of the actual rules and regulations that form the governance pattern, or in other words on the outcome of the policy-making process and its effects on actor behaviour. These studies originate from International Relations, for example, where governance is a logical concept to use in the absence of an overarching government in the international realm. An early contribution to the development of the governance concept in International Relations was made by Krasner's introduction of the concept of regimes. These regimes constrain the formulation of preferences by actors in a certain area of international relations, as actor expectations converge in a given international relations policy domain.[28] Rosenau introduced a more abstract notion of governance by implying that governance concerns the structuring and ordering of society in the absence of sovereign authority. It functions to prevent violent conflict (a Hobbesian state of nature) and to preserve adequate resources for the continued survival of society's members.[29] A rich literature on institutions is also situated in this second strand of literature (this overlaps with the discussion of Historical Institutionalism and New Institutional Economics below). This entire spectrum of literature points to the importance of rules and regulations ('institutions') shaping actors' behaviour, and allows for both public and private forms of governance.

From this diverse literature it appears that the added value of the theoretical development of the concept of governance is twofold. First and foremost, the contribution of governance studies is that they are not only concerned with rules and regulations emanating from states but also with the role of non-state actors in shaping behaviour. The increasing attention to non-state actors has been variably attributed to the perceived rise in international connectedness, new actors in politics such as (transnational) Civil Society Organisations (CSOs) and business coalitions, and new forms of steering of complex societal problems (e.g. privatisation and New Public Management).[30] In the extreme, this could lead to emerging private patterns of governance where state intervention is virtually absent.[31]

The concept of governance consequently helps us analyse diverse forms of rules and regulations that do not necessarily emanate from states. It could be argued that the concept of governance underscores the nature of IPE: it is not only about power struggles among states, but also about conflicts and cooperation between public and private societal actors pursuing their preferences. In other words, it is about both power struggles between public authorities and the private sector, and within the private sector and public sector itself (e.g. struggles between regional and international banks, or bureaucratic struggles between ministries). Governance as

[28] Krasner, 1983.
[29] Rosenau, 1992, p. 3.
[30] Brunnengraeber et al., 2006; Rittberger & Nettesheim (eds), 2008. Whether governance as an empirical phenomenon is really a new response to these developments can be questioned; think, for example, of the governance of private forms of money by medieval merchant networks (Kindleberger, 1993, p. 8).
[31] See, for example, Fransen, forthcoming 2011 for an extensive treatment of private governance regimes in the clothing sector (one of the sectors where private regimes governing labour standards have advanced most). Seminal contributions are Cutler, Haufler & Porter, 1999; and Higgot, Underhill & Bieler, 2000.

an emerging theoretical concept has thus encouraged a critical rethinking of the relationship between states and markets (or society in general) and of the forms of authority that shape these relationships.

A second added value of the governance concept, which follows from the first, is the attention to (possibly newly emerging) problems of accountability and legitimacy.[32] If we include rules and regulations emanating from non-state actors in our analysis, we can no longer be certain that these forms of governance result from democratic procedures aimed at legitimacy (as we would in the case of rules emanating from governments in established democracies).[33] While, for example, the World Bank reduces its conceptualisation of governance mostly to 'government', its 'good governance' agenda was introduced as a way to focus on issues of accountability and responsiveness to citizens' concerns (about corruption) in developing countries' governments. The issue of legitimacy will not be elaborated here in theoretical terms, but the study will consider both cases under study in relation to issues of legitimacy and accountability (particularly in the concluding chapter).

These two contributions made by the concept of governance to the literature show how it can enrich the analysis of the dynamics of the global financial system, providing a more 'complete' picture. Governance is not a static variable, however; the rules and regulations shaping actors' behaviour are in constant flux as are actor preferences in this regard. This draws attention to the impact of such shifts in governance on the structure of markets and the distribution of resources. The way markets function and distribute resources is very much dependent on the rules and regulations that steer the market participants – rules and regulations that can be enacted by government or private sector associations (and hybrid organisations).[34] Governance is therefore an integral part of what allows markets to function, and the way markets work is part of the pattern of governance.[35]

Disentangling multilevel governance

As the discussion above showed, the conceptualisation of governance applies to a wide range of contexts and on different levels. In this thesis, the focus of analysis is financial governance. The 'financial' part of this concept means, in the words of Susan Strange, that it concerns the (international) system for the allocation of credit.[36] Financial governance is then the

[32] Van Kersbergen & van Waarden, 2004, p. 144 and 155 – 160. See the introduction and further contributions to the volume by Underhill, Blom and Mügge, 2010b that analyses the legitimacy issues in global financial governance throughout the volume.
[33] The same would apply if we extent our political economic analysis to states with less clearly established democracies.
[34] Compare, for example, the literature on regulation: Vogel, 1996; Jordana & Levi-Faur, 2004.
[35] Cf. Underhill's state-market condominium conceptualisation, Underhill, 2003 and 2007b.
[36] Strange, 1996. Compare also Allen & Gale, 2001 who conceptualise a financial system as a set of markets for assets and liabilities and the actors (individuals and institutions) who interact on this market.

rules and regulations that steer the behaviour of actors involved in the allocation of credit.[37] Especially after the fall of the Bretton Woods system the internationalisation of the financial system accelerated, giving rise to emerging patterns of 'global financial governance', which refers specifically to the rules and regulations that shape actors' behaviour on (cross-border) financial markets.

The internationalisation of financial markets also led to a shift in attention to the interaction between governance patterns at different levels, or so called multilevel governance. This gives "expression to the idea that there are many interacting authority structures at work in the emergent global political economy," and consequently also includes the notion of public and private authority and their interrelationship.[38] Since the term 'level' is not meant to imply hierarchy, depicting financial governance as multilevel allows for a more subtle distinction than e.g. the national versus the international level. In other words: the global does not necessarily trump the national level, or vice versa.

Shifts in governance may take place from one level to the other. For example, had the Sovereign Debt Restructuring Mechanism of the IMF materialised, the global level would have gained substantially in importance vis-à-vis the domestic level in sovereign debt restructurings. Furthermore, by using the concept of multilevel governance, attention is also extended to levels not easily captured in pure jurisdictional terms, such as advanced 'footloose' or 'virtual' financial markets. The concept of multilevel governance draws our attention to the interaction between these levels, which is one of its main contributions.

The case study descriptions in the Introduction showed that changes in the pattern of governance were not one-dimensional. To gain the full benefit of understanding the interaction between the different levels of governance, however, different shifts in governance that can take place should be disentangled. Lumping different shifts together would lead to fuzzy analysis, as there might be different explanations for different sorts of shifts. Therefore, in this study three dimensions across which shifts in governance may occur are distinguished. First, the level of governance as a matter of jurisdiction, second the nature of the 'owner' of the rules (public versus private) and third the level of stringency (the degree to which the rules constrain the behaviour of actors acting under them). Each of these dimensions helps us understand the forms shifts might take, and taking them together could lead to an improved understanding of shifting patterns of governance. The three dimensions are further elaborated below.

[37] This conceptualisation is based on Germain, 2010, p. 11. It should be noted, however, that he includes an explicit normative element by emphasising that behaviour should be "sound and efficient". He also explicitly mentions the role of norms. In my view, these should also be seen as incorporated in my conceptualisation above (under the rubric of rules).

[38] Baker, Hudson & Woodward, 2005, p. 14. See the edited volume by Baker, Hudson & Woodward for applications of the concept of multilevel governance and the state-market condominium to finance. Hooghe & Marks, 2003 provide a state-based typology of multilevel governance.

The first dimension in the governance of global financial markets concerns the level of governance in a jurisdictional sense, in other words designating in which jurisdiction (or 'level') the rules that shape behaviour are embedded. Shifts across this dimension determine the political community directly affected by the governance pattern.[39] For example, a shift upwards on this dimension means the same rules apply to multiple jurisdictions. On the one hand, this might reduce 'policy space' for actors in one jurisdiction, as the rules emanate from a higher level. On the other hand, it facilitates cross-border activity as the applicable rules are the same. As governance is the outcome of a policymaking process, shifts upwards imply that a policymaking institution or cooperative process at this higher level has facilitated decision-making. This links shifts on this dimension to legitimacy questions: is a shift upwards accompanied by proper representation on the input side? Does the policymaking institution at the higher level include all jurisdictions that adopt the governance pattern? This might not necessarily be the case ex ante: for example, the Basel Capital Accords were adopted by many non-BCBS states.

Although this dimension conceptually includes the subnational level, in this study the jurisdictional dimension extends from the national level upward (subnational financial regulatory units are mentioned in passing if relevant). In other words, shifts in governance along this dimension go from states to groupings of states (either 'international' or regional like the EU) to the global level and vice versa. As the dimensions are continuous, the question can also be how mechanisms of governance are distributed across levels; the CACs, for example, are subject to a global level standard but are implemented nationally. Another aspect of this dimension of governance which comes to the fore in the literature is the question of national distinctiveness versus global convergence, in other words the domestic implementation of international standards.[40] Analytically disentangling these aspects under a first dimension of multilevel governance provides the building blocks for our understanding of state actors in a global financial system.

The second dimension refers to the nature of the authority that implements the rules by which international financial markets are shaped; is this public or private authority (or a mixture of both)? Public authority is responsible for general interests and affairs of the social collective; it is hence associated with citizens and the state. Private authorities are accountable to particular interests (which strictly speaking includes both business and CSOs).[41] This public-private distinction closely corresponds to the state/non-state distinction.[42] This also

[39] Due to economic linkages, shifts in governance in one political community might also indirectly affect other communities, for example when the international level Basel I Accord (implemented in the G10) discouraged investments in non-OECD states. These indirect effects are not taken into account in analysing this dimension.

[40] Walter, 2008 and 2010.

[41] I will pass over the debate to what extent public authorities really succeed in representing the 'general interest'.

[42] Weintraub, 1997, p. 5. The volume edited by Weintraub provides a fundamental treatment of the public-private distinction as the 'grand dichotomy of Western thought'. See also Horwitz, 1982.

implies that 'public' is distinguished by "the use of legitimate coercion and the authoritative direction of collective outcomes."[43] These collective outcomes are supposedly based on the preferences of the whole political community, and not those of particular collectives within that community. There is a continuum ranging from the exertion of public authority in government to governance by private authorities (often entailing private governance or self-regulation), with hybrid forms in between (e.g. public-private partnerships).[44]

Whether the nature of authority is public or private is especially relevant given its implications for legitimacy and accountability. Private authorities usually lack mechanisms for democratic legitimation, nor would such a mechanism be necessary per se (following the reasoning that they work for the benefit of their constituency, e.g. shareholders).[45] However, the costs and externalities generated by private governance may be born by the public, as is often the case with financial crises. Furthermore, shifts across this dimension have implications for the power relations between public and private actors in subsequent policymaking processes. When implementation is delegated to private actors, these gain an information advantage on public actors, increasing the power of these private actors in the policymaking process, for example through agenda control (see also the discussion of the ideational factor in policymaking processes below).

The third dimension of governance is the level of stringency or compellence, indicating to what extent actors are constrained by governance mechanisms. This concerns the leeway actors have to make their own choices in following the aims of the rules, and how rules are ultimately enforced. This dimension is especially important for future developments of and innovations in financial markets – and hence the market structure – as, for example, the development of new financial services might be either forbidden or allowed under more or less stringent regulations. Arguably, this dimension, even more than the others, determines the likelihood that financial instability might affect societies: granting private financial actors more leeway allows them to create greater havoc when things go wrong, just as it might encourage innovation.

Fransen (2011) divides stringency into the scope of the governance pattern, implementation specificity, and control mechanism.[46] The scope variable signifies different elements of the policy domain to which the governance pattern applies. In this thesis, the cases do not vary on the scope variable. However, the latter two elements provide useful tools to operationalise the stringency dimension. The element of implementation specificity is reflected in the field of financial governance in the debate on 'principles-based' versus 'rules-based' prudential regulation.[47]

[43] Weintraub, 1997, p. 36.
[44] Mügge, 2006 provides an interesting argument relating shifts along this dimension to changes in the market structure.
[45] Hence Friedman's famous dictum "the social responsibility of business is to increase its profits" (Friedman, 1970).
[46] Fransen, 2011, chapter 3 develops an index for stringency of private sector self-regulatory labour standards in the clothing industry based on these three elements.
[47] This debate gained traction in the policymaking process just before the crisis broke out. See the speeches by Bernanke (15 May 2007) and McCarthy (13 February 2007).

Principles-based regulation communicates a regulatory aim to market participants while leaving them to find the way to act in accordance with this aim. Rules-based regulatory systems to a much larger extent also determine how to achieve the aim, shaping behaviour of actors more directly. Rules-based governance is consequently more stringent. The element of control mechanisms concerns the actual implementation of the rules or principles and sanctions in case of non-compliance. In a market-based governance pattern this is left to (private) market actors via their transactions, which implies a less stringent governance pattern than one where rules or principles are directly enforced by a 'higher authority'.[48]

To summarise, financial governance refers to the rules and regulations that shape the behaviour of actors on (international) financial markets. By distinguishing these rules and regulations along the three dimensions of level, nature and stringency, the concept of financial governance is clarified and a better analysis of how the patterns of governance have shifted in the issue areas of the cases may be enabled. As the discussion above showed, the different dimensions each shed light on different aspects of the legitimacy of governance patterns. Also, the distributional consequences and the impact of changing governance patterns is highlighted and clarified by unpacking multilevel governance in this manner. Finally, this 'unpacking' of the concept also enables us to theorise more clearly on what causes shifts in governance. The next section takes a first step in this direction.

Institutional approaches to governance

As mentioned above, the concept of governance has roots in a variety of disciplines, which unfortunately also on occasion leads to confusing terminology. For example, an important strand of literature that implicitly explains governance is rooted in Sociology and Economics and discusses institutions.[49] It is this literature that will be used as a starting point towards our explanation of governance. Douglas North's conceptualisation of institutions can serve to illustrate the similarities between the conceptualisation of institutions and governance. As one of the most distinguished new institutional economists, he has defined institutions as "the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange."[50] This closely mirrors 'rules and regulations shaping the behaviour of actors.'

[48] See also Treib et al., 2007, p. 5-7 on the elements of stringency.
[49] Note that although the institutional literature fits into the conceptualisation of governance as developed in this thesis, it is likely to overlook the added value of the governance concept that was pointed out above. Especially the issue of legitimacy and accountability is often only dealt with cursorily.
[50] North, 1990, p. 3.

Although there are many 'institutionalisms', the contributions in this field are usually classified as 'historical institutionalism' (HI), 'rational choice institutionalism', 'sociological institutionalism' or the newly emerging 'discursive institutionalism'.[51] Given the focus of this thesis, the discussion below concentrates on historical institutionalism and rational choice institutionalism (more specifically, New Institutional Economics, NIE) as these strands of institutional literature have been most concerned with explanations of institutions focused on respectively the state or the market. Also, interestingly, while one is based in micro foundations (rational choice for NIE) the other is more rooted in macro processes (HI). The role of ideas and discourse, which is a central contribution of discursive institutionalism, will come back in the discussion of the role of ideas in policymaking processes below, as will the social construction of rationality – one of the central tenets of sociological institutionalism.

The different types of institutional literature are not unrelated in conceptual terms and theory development often takes place across the borders between two types. For the sake of exposition, in the discussion below 'hard boundaries' will, however, be drawn around HI and NIE – boundaries that might result more from disciplinary affiliation in Economics or Sociology than actual content of the theories.

Historical Institutionalism

Historical Institutionalism mainly focuses on state institutions and structures.[52] It has therefore been associated with the previous call to 'bring the state back in'.[53] As the name suggests, it studies institutions from a historical perspective, showing the origins and development of institutions and institutional complexes over time. The HI perspective has made important contributions to the 'varieties of capitalism' debate, by showing the historical continuity of the institutional complexes underpinning the varieties of capitalism.[54] The complementarities between institutions which emerge over time lead to different modes of state-market relations, which may all be economically successful. From an evolutionary economics perspective, it has been shown through formal modelling that this leads to stable institutional set-ups (although hybridisation of systems is a possible avenue for change).[55]

Financial globalisation has presented a challenge to the traditionally domestically oriented HI theories.[56] However, HI can be extended to the international level by, for example, allowing the stable domestic institutional set-up to function as an explanatory factor for the preferences and capabilities of state actors in international negotiations. Constituencies are formed for certain state actors, which leads to a 'locking in' of their preferences. In this way, the domestic

[51] See, for example, Schmidt, 2006.
[52] Schmidt, 2006, p. 104.
[53] Evans et al., 1985.
[54] Hall & Soskice, 2001; Becker, 2009. For an analysis from an Economics perspective, see Allen & Gale, 2001.
[55] Hölzl, 2006.
[56] Hall & Soskice, 2001, p. 64; Deeg & Jackson, 2007, p. 154 – 155.

institutional context determines which actors participate in international negotiations, and what their preferences are.[57]

The HI approach has the added value of relating the interests of actors to the historical development of their institutional context, and showing how path dependency and lock-in effects occur. It is these effects that provide HI with explanatory leverage. In the important contribution of Pierson to this literature, path dependence results from self-reinforcing or positive feedback loops.[58] It makes alternative patterns of governance increasingly costly for actors. This would fit with rational choice institutionalism in the form of NIE discussed below. However, importantly, HI diverges from NIE as path-dependent processes can also follow from, for example, power relations (dominant actors retain their power on a certain path) and legitimacy logics (paths are seen as morally just or appropriate).[59] The existence of path dependencies leads scholars in the HI tradition to search for critical junctures at which the choice between one or the other path was made.

A related form of institutional path dependency is based on reactive sequences. Reactive sequences follow from a key breakpoint in history, and can be logically derived from this breakpoint.[60] These breakpoints usually are what economists would call 'exogenous shocks', and it has been argued that financial crises might function as such breakpoints leading to a response in the form of a new governance pattern.[61] This gives rise to explanations of shifts in governance that are informed by financial crises and the policy reaction to them. Less drastically, the complexity of institutional patterns in globalised financial markets and redundant capacity might offer alternative institutional solutions to emerging problems. This allows actors to 'break the path' in response to changing circumstances without the need for full-blown financial crises.[62]

A problematic aspect of the HI literature, however, is that the interaction between actors, which leads to these path dependencies, is underspecified. As Mahony notes: "most historical sociologists have not specified exactly how a focus on processes, sequences, and temporality underpins path-dependent explanation."[63] It remains an open question for HI theories at which moments actors seek change, and why certain paths are chosen.[64] HI implies a relationship between economic change and shifts in governance, but provides no systematic explanation of this relationship.

Moreover, HI can appear historically determinist: formative moments and issues of timing and sequence set the path after which little agency is left, or at least only at high costs (a

[57] Farrell & Newman, 2010.
[58] Pierson, 2000, p. 251. See also Mahony, 2000.
[59] See Mahony, 2000, table 1 (p. 517).
[60] Mahony, 2000.
[61] E.g. Bird, 1996.
[62] Crouch & Farrell, 2004.
[63] Mahony, 2000, p. 510.
[64] Deeg & Jackson, 2007, p. 163 – 164. See also Drezner, 2010.

very restricted choice set). Culpepper, for example, notes that legal changes alone do not suffice for real change, but rather a 'joint belief shift' is necessary to drive institutional change.[65] While theories of institutional change have been developed under HI, these also point to the underlying continuity in structures.[66] To these criticisms we return below, after discussing NIE as representative of rational choice institutionalism.

New Institutional Economics

New Institutional Economics is a rational choice institutional perspective associated with the discipline of Economics that addresses questions of governance. When discussing governance from an Economics perspective, as a point of departure it could be noted that in the general equilibrium framework of neoclassical economics, rational actors interacting on the basis of their material interests spawn a spontaneous order that tends towards equilibrium.[67] This does not necessarily means that (financial) markets would be stable, however; exogenous shocks could still cause crises. However, the implication of the general equilibrium framework is that 'governance' can be limited to ensuring property rights (and arguably transparency, although complete information is usually just assumed), which could also be provided through the market mechanism.[68] These theories consequently pay little attention to the interaction between public and private actors, or the role of the state and the preferences of its agencies. Public actors are portrayed as exogenous (a clear dichotomy between states and markets). The empirical relevance of these theories can be doubted: historically there has always been a close relation between the emergence of states and markets.[69]

Although not necessarily inspired by this empirical puzzle of the significance of states in real-world economics, criticism emerged on the general equilibrium framework of neoclassical economics from the 1970s onwards. One set of criticisms focused on the problems of asymmetric information.[70] Information asymmetries arise, for example, in financial markets when the actor demanding funds has more information on the way these funds will be used than the provider of these funds (which is almost by definition the case). For example, a country issues bonds claiming it will invest in its infrastructure and thereby raise its potential economic growth. However, the buyers of the bonds have no way of being certain that the funding provided will not be used instead to satisfy other interests through unproductive government spending (e.g. maintaining a monarchy). Therefore, lenders need to monitor the actions of borrowers to ensure timely repayment and/or borrowers need a credible signal that

[65] Culpepper, 2005.
[66] See Streeck & Thelen, 2005.
[67] See for a criticism of the possibility of attaining general equilibrium Barry-Jones, 1988.
[68] Eggertsson, 1990.
[69] The classic reference for this point is Polanyi, 2001 (1944); contemporary elaborations are provided by Tilly, 1992; Fligstein, 2001; and Schwartz, 2010.
[70] In 2001, Akerlof, Spence and Stiglitz shared the 'Nobel Prize' in Economics for developing the analysis of markets with asymmetric information. For its application to monetary economics, see Stiglitz & Greenwald, 2003. Classic references are Akerlof, 1970 and Spence, 1973.

they are creditworthy. Financial markets especially are prone to information asymmetries, but in general markets almost always exhibit information asymmetries.[71] In case of information asymmetries, interventions in the market exist that would improve efficiency. In other words, there is a theoretical case for governance.

Information asymmetries can lead to transaction costs, as the parties to a transaction spend time and money to reduce the asymmetry (by, for example, signalling of the party with an information advantage or information gathering by the party with an information disadvantage). More generally, when the assumption of full information does not hold up, transaction costs emerge. This offers a second and related micro-level challenge to the neoclassical general equilibrium theory. Transaction costs are "the costs that arise when individuals exchange ownership rights to economic assets and enforce their exclusive rights."[72] This could, for example, be the time and resources spent gathering information about competing offers, but also the drafting of contracts and the enforcement of such contracts.

These insights into the functioning of the market and their relation to governance patterns were generalised in what has become known as New Institutional Economics. This bundle of literature builds on neoclassical economics by taking transaction costs into account, yet stays within the rational choice framework to explain the emergence of institutions and organisational patterns ('governance' in terms of this thesis) as part of how economies and markets work.[73] An important point is that institutions structure incentives (i.e. perceived material interests) in human exchange.

NIE points to transaction costs as the explanatory factor for the emergence of private actors such as financial intermediaries,[74] but also public institutions such as property rights. NIE shows how actors reduce transaction costs by collectively developing institutions that enforce property rights. These institutions are needed to reduce transaction costs and thus to make well-functioning markets possible. The existence of transaction costs consequently provides a functional need for governance mechanisms to ensure that (financial) markets function.

However, unlike the situation implied by neoclassical economics, the institutions need not be socially optimal or efficient.[75] North makes the distinction between institutions (the rules) and organisations, which try to maximise their utility within the constraints of the current set of rules.[76] This links to the literature on rent seeking, where organisations try to

[71] Stiglitz, 2001.
[72] Eggertsson, 1990, p. 14.
[73] The seminal reference is North, 1990. See also Eggertsson, 1990. Eggertsson makes a distinction between neo-institutional economics (which leaves rational choice assumptions intact) and new institutional economics (which uses bounded rationality assumptions like satisficing). This distinction does not seem to be used consistently in the literature, and here both types of institutional economics are referred to as New Institutional Economics.
[74] A classic reference is Williamson, 1975.
[75] Acemoglu, 2003.
[76] North, 1990, p. 7.

increase their utility by maintaining the current set of rules.[77] This creates lock-in effects and path dependency, allowing this theory of governance and institutional change to account for the continuing existence of inefficient institutions in a rational choice framework. Governance is integral to why some markets work better than others; it is consequently the relation between governance and the market that is important.[78] We will return to this point below in the discussion of the relation between market structures and governance patterns.

Although this literature provides a clear explanation of the *functional* need for governance, and provides a motivation and idea of preferences in relation to the interaction of material interests, it provides fewer clues as to how the specific shifts along the dimensions occur. It mainly accounts for *why* governance should be there, without showing *how* or *what sort* of governance emerges. As Eggertsson states, "rational individuals will compete not only to maximize their utility within a given set of rules, but also seek to change the rules and achieve more favourable outcomes than was possible under the old regime."[79] How this rule change comes to be, in other words the application of NIE to policymaking processes, is underdeveloped.[80] A functionalist assumption of efficient policymaking processes seems, at best, to hold sway – provided decisions are not just assumed to emerge as manna from heaven. Eggertsson rightly acknowledges that consistent implementation of NIE would also extend to policymaking processes.[81] North has argued that a successful theory of institutional change requires both a theory of the state as the main policymaking actor and theories of ideological behaviour.[82] This criticism coincides with the aforementioned criticism on HI that it underspecifies how the process of path dependence or a breakthrough actually works. At what point do actors collude in choosing a new departure indicating a shift in governance?

A first step in addressing some of these challenges to NIE has been taken by Acemoglu, Johnson & Robinson (2004). They propose a model where political institutions and the distribution of resources lead to political power that translates into changes in economic and political institutions. These changes influence subsequent economic performance, and (crucially) the distribution of resources. In other words, the distribution of resources (market structure) leads to changes in governance (economic institutions), which feeds back into the market structure. The account of Acemoglu, Johnson & Robinson of the policymaking process is still rudimentary, however (as will be elaborated below, they give scant attention to some of the central explanatory factors for policymaking processes coming out of the literature; attention to the role of ideas is minimal, for example). More importantly, their model is oriented at the domestic level and it is unclear how it would extend to the international level (in other words, how it would function in a multilevel governance framework).

[77] Krueger, 1974. See further below.
[78] Acemoglu, Johnson & Robinson, 2004.
[79] Eggertsson, 1990, p. 13.
[80] See Acemoglu, 2003 and Acemoglu, Johnson & Robinson, 2004.
[81] Eggertsson, 1990.
[82] North, 1981, chapter 6. North also points to the need of theories of demography and technological change.

To summarise, both HI and NIE predict institutional stability (an issue to which we will return below). This stability seems only to be punctuated by exogenous shocks, leading to a crisis-driven explanation for shifting patterns of governance. Furthermore, both bundles of literature underspecify how the policymaking process leading to institutions can be characterised. There is therefore an explicit need for interdisciplinary tools for analysing the policymaking process. We can turn to the insights of the Political Science and Political Economy literature to shed light on this second problem. By examining how policymaking processes actually work in a context of power relations and political constraints we can get a better understanding of which institutions actually emerge under HI or NIE. In other words, to explain governance (output side) we also have to look at the input side, the policymaking process that leads to decisions that yield inertia or change. To this we turn in the next section.

Analysing the policymaking process

The literature on policy networks and policy communities is a useful point of departure to address the extensive literature on policymaking processes.[83] Given the relevance of patterns of governance for socio-economic outcomes, there is a wide variety of demands on the policymaking process leading to a governance pattern. This wide variety of preferences and the degree and pattern of interaction among the actors holding them constitutes the policy network. Policy networks emerge around specific policy domains (in this thesis, bank capital adequacy and sovereign debt crisis resolution). Within the policy network groups can emerge whose members have a strong level of shared beliefs, values and interests to the extent that they share preferences. These groups often provide a framework for political action as advocacy coalitions.[84] More importantly, in the policy network, there is a specific subset of actors who can reach authoritative decisions: the policy community.

Although the literature on policy networks and communities offers a useful categorisation to apply to policymaking processes, it offers less insight into the actual content of the policymaking process and how it can be explained. Plotting out the different actors and their relations does not automatically lead to an explanation of the process that emerges when they start interacting.

In the 'open range'[85] of (International) Political Economy, much work has been done which offers an in-depth analysis of this interaction in the policymaking process. These theories range from public choice approaches (basically applying the lessons of neoclassical economics to political processes) to poststructuralist approaches focusing on the social construction of

[83] For the conceptual confusion in the policy networks and policy communities literature, see Atkinson & Coleman, 1992, p. 158. See also Coleman & Skogstad, 1990; Dowding, 1995; and Coleman & Perl, 1999.
[84] Sabatier, 1988.
[85] Strange, 1984, p. ix.

identities and ideologies. Three key factors have emerged in the literature with respect to the interaction in and outcome of policymaking processes: material interests, ideas and institutions.[86] Different approaches have each emphasised different factors, conceptualised them differently and theorised different relations between them. Moreover, different approaches focus on one or both of two steps in policymaking: firstly the formation of actor preferences, and secondly the interaction among actors. This section discusses the different factors, and also shows the weaknesses of focusing on any one of them exclusively.

Material interests

The literature seeking to explain the outcome of policymaking processes as a function of (material) interests is often identified as part of the rational choice tradition. In line with the steps in policymaking introduced above, two issues are at stake: first, how to conceptualise material interests and the resulting preferences of actors; and second, how to aggregate the preferences during the interaction in the policymaking process into formal explanations of the outcome. In the discussion below we start with approaches developed out of the Economics discipline.

The public choice approach is an important bundle of literature explaining policymaking processes from a material interest perspective.[87] These apply the neoclassical insights to politics. An important contribution to this literature was made by Anne Krueger with the introduction of the notion of rent seeking.[88] Rent seeking occurs when market actors seek regulations not to solve market failures, but to protect and enhance their interests. An example is when incumbent banks lobby to limit the number of new banking licences granted by financial authorities. This does not solve a market failure, but serves to limit competitive pressures on these banks and hence increases their profit-making potential, in line with Adam Smith's statement: "widen the market, narrow the competition."[89]

It has been argued that Marxist economics is interest-based too.[90] In this strand of theory, it is not so much individual actors satisfying their interests, but rather their aggregates into classes. The class struggle concerns the division of the social product, with each class – or fraction thereof – trying to maximise its share (or in the case of labour: minimise the extraction of social surplus).[91] Both public choice and Marxist-oriented approaches consequently

[86] Interests, ideas and institutions is the usual parlance to refer to the debates surrounding these explanatory factors in policymaking processes. As will become clear from the discussion below, different approaches sometimes use slightly different terms for the factors; more importantly, however, institutions here refers to policymaking institutions, or in the words of Eggertsson: "formal political and organizational practices" (Eggertsson, 1990, p. 70).

[87] For an overview, see Mueller, 2003.

[88] Krueger, 1974. Anne Krueger later became the First Deputy Managing Director of the IMF and championed the Sovereign Debt Restructuring Mechanism.

[89] Smith, 1991 (1776), p. 232.

[90] Mandel, 1990.

[91] Mandel, 1990, p. 8.

assume rational actors maximising their utility (usually measured as – monetary – gain or 'accumulation').

There are several problems with the utility-maximising, interest-based approach. First, it is debatable whether market actors are indeed in cut-throat competition to maximise utility, as the public choice theorists assume. Rather, as sociological institutionalists argue, market actors seem to focus on the creation of stable social 'fields'. As Fligstein points out, "The sociology of markets that I am developing replaces profit-maximizing actors with people who are trying to promote the survival of their firm."[92] This view links to the recent insights of North on the role of uncertainty (as opposed to risk) in economic change.[93] At a general level, these insights imply that agents seek control over their environment, reducing uncertainty. Firms do this by building an efficient internal organisation in order to compete with rivals, but also by employing political resources via policy rent seeking. Even where they are aware they will likely not succeed in eliminating competition, they seek to limit competition to what they know, i.e. to companies doing things the same way they do. One way to avoid or reduce competition is by market segmentation.[94] Firms seek to eliminate the uncertainty of radical innovations, new entrants, etc.; in other words they seek to define the terms of competition – what Fligstein calls a 'stable conception of control'.[95]

This sociological conceptualisation of markets leads to a more subtle understanding of what actors' interests actually might be, instead of the one-dimensional view of profit-maximising actors. This diversity of interests is further compounded by the emergence of different types of actors in the policymaking process. CSOs are active in economic governance at both the national and international level. For example, Third World Debt Cancellation advocacy groups have been involved in the sovereign debt restructuring case. When the market is international (and market failures are consequently also internationalised) this furthermore requires extending the public choice approach to the international level. This brings into play state actors negotiating in international policymaking institutions.[96]

The link between the material interests of market actors and the interests of states in international negotiations has been modelled as a two-level game.[97] In this two-level game, state agents try to find a balance between the demands of international negotiations to come to an agreement and satisfy the interests of domestic constituencies (which might be engaged in policy rent seeking).[98] On the one hand, this set-up makes it likely that state interests in international negotiations on global financial governance are closely associated with the interest

[92] Fligstein, 2001, p. 17. It might be noted that Fligstein's analysis of the threats to survival of firms is consistent with Porter's conceptualisation of the market structure which was introduced above.

[93] North, 2005.

[94] Fligstein, 2001, p. 5.

[95] Fligstein, 2001, p. 22.

[96] Besides opening up a whole new bag of potential market failures, coordination problems, etc.; see Kaul, 2008.

[97] Putnam, 1988.

[98] See Underhill, 1997 for country studies in the field of finance showing some of these dynamics.

of the domestic financial community. On the other hand, it also gives public actors an independent and powerful agency as the 'spider in the web'.[99] Next to market actors seeking stability or utility maximisation, public actors also have their own material interests which can be broader than just solving market failures or maximising national economic welfare.[100]

How to aggregate this diversity of material interests in the policymaking process is a problem for public choice approaches. A simple utility maximisation exercise – implicitly based on the same assumptions as the general equilibrium theory discussed above – will no longer do. First of all, it has to be empirically established which actors are 'only' part of the policy network and which are also part of the policy community. Without an account of the institutions of policymaking and the actors involved, we cannot account for the resulting governance pattern. In other words, we need to analyse how the policymaking institutions on which the policy community is based function, and how they relate to the wider network.

Next to this 'static' argument for extending our analysis from solely material interests to policymaking institutions as well, there is also a 'dynamic' argument. The public choice approaches mentioned above suffer from an ahistorical and uncontextualised conceptualisation of material interest. When we look at firms as agents, for example, it can be shown that their driving motive has significantly changed over the decades: from profit maximisation to shareholder value maximisation.[101] Similarly, Cerny has argued that the definition of the interests by state actors has changed from the welfare state to the 'competition state' admitting that the nature of states and their interests are dynamic.[102] When we want to account for shifting patterns of governance, we consequently need to analyse the development of revealed preferences of the actors over time, instead of ex ante determined interests. If we want to know why actors make decisions as they do, material interests should be empirically derived, not a priori assumed.

Furthermore, it should be noted that – as mentioned above – there is no clear ex ante public interest or private interest in the abstract. Public actors are active in credit markets on the demand side and private actors exert authority; their material interests are consequently multifaceted. In developing their preferences, actors simultaneously consider the dynamics of market competition and those of governance patterns.

This endogenous nature of preferences points to the relevance of policymaking institutions (as also mentioned above) and ideas, which might influence the formation of these preferences and the context in which some can realise preferences more readily than others. Material interests cannot serve as an explanation for the outcome of the policymaking process without taking these other factors into account. Before elaborating on the explanatory power of policymaking institutions in policymaking processes, the next section discusses the factor

[99] Cerny, 2005.
[100] See, for example, the debate on office-seeking or policy-seeking political actors, Müller & Strøm, 1999.
[101] Rappaport, 1998; Horn, forthcoming 2011.
[102] Cerny, 1997.

of 'ideas', as the societal embeddedness of actors points to the possible influence of idea-sets on perceived material interests and hence revealed preferences.

Ideas

Several approaches consider ideas in one form or another as a main explanatory factor in policymaking processes. Especially the field of financial governance has been influenced by this approach, given the performativity of finance theory and the reflexive nature of financial markets.[103] As mentioned above, there is an important link between ideas and the formulation of preferences. This also relates to the role of experts in policymaking (as actors expressing preferences), which is often intermingled with analysing the role of ideas in policymaking.[104] Ideas can also play a role in the second step of policymaking (after preference formation): explaining the interaction in the policymaking process. However, the role of ideas in this second step of the policymaking process is hard to distinguish from the role of agents and policymaking institutions in which ideas find expression, and a number of approaches that could also be labelled 'ideational' are therefore discussed in the next subsection on institutions.

In the epistemic communities approach, the explanatory power of ideas is on the one hand portrayed as an almost 'exogenous' force in the policymaking process. Epistemic communities are national or transnational communities of experts who have reached a consensus in a particular policy field and push this consensus on the policy agenda (they consequently express a preference for a certain policy). It could even be said that in this case ideas obtain an agent-like quality in the policymaking process in the sense of a consensus reached by an expert community.[105]

On the other hand, as Adler & Haas point out, epistemic communities do "narrow the range within which political bargains can be struck."[106] This indicates the influence they can have on the interaction in the policymaking process. These explanations are therefore not based on either market or state actors, as was the case with the interest-driven explanations discussed above. To illustrate, it could be argued that the G30's push for the renegotiation of Basel I was the work of an epistemic community, although the inclusion of active policymakers in the G30 means that it does not adhere to the strictest definition.

[103] For an elaboration of reflexivity in financial markets, see Soros, 1998; and see Velthuis & Noordegraaf-Eelens, 2009 for a discussion of performativity in the context of the current financial crisis. Poststructuralist IPE awards an even more prominent place to ideas by pointing out that the financial system, and hence also its governance, is the result of historically contingent social and discursive practices (e.g. Dodd, 1994; De Goede, 2003 and 2005). It can be doubted, however, whether the insights of poststructuralists add analytical leverage to the puzzle addressed in this thesis. This literature tells us little about how actors, who most likely do not share the deeply critical attitude of the poststructuralists but rather work in their daily 'reality' and are held accountable for their concrete actions, interact to bring about shifting governance patterns. Without a more extensive focus on the agents promoting certain conceptualisations of finance, the poststructuralists see their discursive power struggle in an ideational realm, which is in the end devoid of practical meaning.
[104] See also the discussion of Horn, 2009.
[105] Haas, 1992. For an application to financial governance in the context of the EMU, see Verdun, 1999.
[106] Adler & Haas, 1992, p. 378.

The epistemic communities approach, however, seems not to acknowledge that there might actually be competition between different expert groups with different solutions, nor that the eventual selection of outcomes is unlikely to be disinterested. This seems to suggest that the knowledge is apolitical and not linked to material interests, which is clearly not the case. Expert groups often have internal conflicts and represent different parties in the process. As a source of explanations for the outcomes of policymaking processes, the epistemic communities approach is consequently rather shallow. It could explain them as the result of expert consensus, but that only begs the question how this consensus emerged to dominate the policymaking process given the contested nature of financial governance: who chose the experts from the available community of experts? Verdun nuanced this apolitical nature of the epistemic community somewhat by pointing out that "the notion of an 'epistemic community' requires the members to have a commitment to a political goal and to interpret their knowledge in such a way that it supports their goal."[107] However, having a political agenda still does not tell us which ideas developed into the epistemic community's consensus and why.

In an influential contribution to the debate, Goldstein & Keohane posit three types of ideas: world views, principled beliefs and causal beliefs. These beliefs have an influence on both steps in policymaking. They can serve as an explanatory factor for preference formulation because they provide roadmaps for actors regarding their goals or ends-means relationships and by guiding decision-making in the face of multiple equilibria. They furthermore serve as an explanatory factor in the policymaking process by becoming embedded in political institutions (e.g. administrative procedures of policymaking institutions).[108]

Ikenberry (1992) has overcome several of the strictures of the 'pure' epistemic community approach by showing how ideas can become embedded in political institutions. He focuses less on the consensus with respect to the political agenda, and more on a common problem definition and yardstick against which to measure solutions as the source of the influence of expert groups on the policymaking process. This ideational factor consequently provides an explanation mostly oriented at the interaction in the policymaking process.[109] Having a common problem definition and yardstick shapes discussions in the policymaking process (e.g. by excluding courses of action that the yardstick does not measure).

While ideas are clearly important for a valid account, a drawback of the use of ideas as the main explanatory factor is that it offers few clues on how ideas lead to certain shifts in governance and why actors select the ideas that they do. Why did the G30 and the IIF lobby for a revision of the Basel I Accord towards Basel II based on risk-weighted capital standards via internal risk management models? Why did the idea of a global level solution to the problems of banking supervision (as opposed to national level supervision) emerge in the first place? Focusing too strongly on ideas as the only relevant factor runs the risk of providing an apolitical analysis of political issues. As Cox famously pointed out: "theory is always for someone, and for some purpose."[110]

The ideas dominating the policymaking process should therefore be seen in relation to the preferences (interests) of actors propagating them. The role of ideas should be politicised in the sense that the selection of people involved in expert groups can co-determine the outcome of the discussions. It also seems that the expert consensus only occurs after the policymakers have started participating in the negotiations, suggesting policymaking institutions are relevant as an explanation as well. These will be discussed in the following section.

Institutions

The discussion of the other two factors above has already hinted at the importance of institutions in the policymaking process. The policy community is typically embedded in certain policymaking institutions, like in our cases the IMFC, G7 or the Basel Committee. Interaction of actors within such institutions can serve as an explanation for the outcome of the policymaking process in several ways, but first it should be underscored that these institutions are of a different type than those of HI and NIE. Institutions here concern the "political and organizational practices"[111] specifically pertaining to policymaking processes, and are hence more narrowly confined than institutions as 'the humanly devised constraints on actor behaviour.'

Policymaking institutions influence the first step in the policymaking process (preference formation) in a number of ways that are closely related to the interaction within the institution. They can serve as an explanation for actors' preferences through processes of groupthink and skewed argument pools that occur during the interaction in the policymaking process. With respect to the second step (interaction in the policymaking process), it could be argued that policymaking institutions might influence the interaction in the process due to their exclusionary nature and internal decision-making procedures (such as voting weights). Institutions provide advantages for specific sets of actors, shaping power relations and patterns of inclusion and exclusions. The aforementioned shows, however, that the two steps in policy-making are hard to separate in the case of policymaking institutions. For example, the exclusionary nature of a policymaking institution logically precedes the development of groupthink or skewed argument pools. That being said, the various ways in which institutions factor in policymaking processes are elaborated below.

Sociological approaches to negotiations in the policymaking process have shown that the interaction of policymakers within policymaking institution influences preference formation

[107] Verdun, 1999, p. 320.
[108] Goldstein & Keohane, 1993. See also Blyth, 2002a and 2002b.
[109] Ikenberry, 1992.

[110] Cox, 1981, p. 128.
[111] Eggertsson, 1990, p. 70.

and articulation through groupthink. When a small group of (in our case) elites interact on a regular basis, it has been shown that individuals fear to dissent from the general thrust of the argumentation.[112] The expression of preferences hence is shaped by the deliberation in a policymaking institution. For example, once a certain 'yardstick' for proposed solutions is agreed on, the discussion of solutions excluded by this yardstick becomes hampered.[113] In itself, however, groupthink tells us little about which specific consensus preference emerges from a group, which brings us to the role of skewed argument pools.

In restricted groups, the argument pools (which form the basis of groupthink) might become skewed. Not all arguments for and against certain solutions are weighted equally, or even weighted at all.[114] When argument pools are skewed, the range of policy options considered narrows. Both groupthink and skewed argument pools are more likely to occur in exclusionary 'clubs', where membership is, for example, selected on the basis of a common professional background. Baker argues persuasively how these different effects occur in the case of the finance ministers and central bank governors of the G7.[115]

As mentioned, prior to the emergence of groupthink or skewed argument pools, certain groups of actors (and their preferences) are often excluded from policymaking institutions. By insulating policymakers from other demands, policymaking institutions narrow the range of policy options.[116] Being granted access to 'club-like' policymaking institutions is therefore crucial for actors if they want to satisfy their preferences (reversely, keeping actors with diverging interests out of the policymaking institutions is one of the most effective ways of improving the chances of getting one's own preferences satisfied and is therefore an important part of the political struggle concerning global financial governance). Being able to embed the policymaking process in an exclusionary policymaking institution gives structural power to those able to do it.[117] This structural power can be enhanced by decision-making procedures that favour certain preferences. This is obviously the case with different voting weights, but also for example the IMF Executive Board's habit of making consensual decisions creates a structural bias against radical change.

However, similar to the other factors mentioned above, institutions can only account for shifts in governance in combination with the other factors (interests and ideas). Policymaking institutions are relevant in that they might shape and bias the policymaking process, but they might only partially account for the preferences that form the actual inputs into the policymaking process. In short, integrated accounts of all three factors should be developed to gain leverage over the dynamics of policymaking processes.

[112] The classic reference is Janis, 1972 who examined several 'war-and-peace' decisions of the US. Baker, 2006 and 2010 has applied these arguments in his analysis of global financial governance.
[113] Cf. Ikenberry, 1992.
[114] See Sunstein, 2002 on skewed argument pools.
[115] Baker, 2006.
[116] Martin, 1977 argues that insulation from popular demands of capitalist industrialising elites in policymaking institutions (the 'political structure') is crucial for the onset of industrialisation, and subsequently the political structure continues to limit the range of possible economic development strategies through this insulation.

An integrated account of the policymaking process

In other words, as the discussion of the three factors above has underscored, analytical leverage is gained less by looking at any one of them in isolation than by linking them in an integrated account of the policymaking process. Each factor on its own underspecifies the actual agency and dynamics in policymaking processes. There are drawbacks to the emphasis on any one of the factors, and these drawbacks are usually linked to the exclusion of the other factors. In short, more theoretical leverage can be achieved if we combine the three factors in a coherent framework that links preferences and behaviour of actors with their interaction in markets and in policymaking processes, leading to collective institutionalised outcomes. There are too many linkages between the three to render explanations focused on any one of the three particularly useful. For example: it needs to be understood how policymaking institutions might lead to the adoption of certain idea sets; it needs to be understood how idea sets influence the preferences actors adopt; and we need to know how policymaking institutions constrain some actors and facilitate the expression of preferences of others.

Gramsci and his later followers in the neo-Gramscian tradition can serve as a source of inspiration for such an integrated account.[118] This bundle of literature provides a fully integrated and coherent perspective on the relationships of the three factors playing a role in explaining shifting patterns of governance, and hence overcomes many of the drawbacks mentioned above. The concept of hegemony has a central position in the neo-Gramscian approaches, and "appears as an expression of broadly based consent, manifested in the acceptance of ideas and supported by material resources and institutions."[119]

Turning to the three factors central in this section, the material interests of the different actors in the Gramscian model follow from their position in the social relations of production. In other words, the material interests are largely determined by the position in the class structure derived from a specific historical mode of production. However, the innovation of Gramscian approaches over more traditional Marxist approaches was that it is more agent-centric. A dichotomous view of capitalists versus labour is nuanced by fractions of capital and a variety of actors in different coexisting modes of production. Hegemony, as a product of dominant ideas and interests, could be achieved by a compromise among a number of these collective actors. As an example, the implementation of Basel II in the European Union was pushed by a coalition of banks with a transatlantic orientation in concert with public actors in favour of further European integration. As a neo-Gramscian account of the Basel II policymaking

[117] See Strange, 1988 on structural power.
[118] See for prominent examples Gill, 1993 and Cox, 1987. For an application to financial governance, see Soederberg, 2004.
[119] Bieler & Morton, 2004.

process argues, this coalition overcame opposing interest from other fractions of capital.[120]

The second factor (ideas) is integrated in the neo-Gramscian framework through the role of organic intellectuals, who are interlinked with material capabilities and institutions.[121] These organic intellectuals play an important role in the shaping of ideology in support of the specific historic bloc or 'hegemony' of which they are part, which subsequently can shape the preferences of important actors, as happened in the shift from Bretton Woods to a more liberal financial order, for example.[122] This approach has the clear benefit of immediately embedding the ideational factor in wider societal forces, and hence offers better clues as to how a certain expert consensus can emerge.

The third of our explanatory factors (institutions) is a central element in stabilising a particular order. In Cox's conceptualisation, institutions are an amalgam of ideas and material interests.[123] Institutions facilitate negotiation between labour and capital.[124] This implies that they are policymaking institutions, with accompanying rules and procedures.

The neo-Gramscian literature consequently combines the three factors characterising policymaking processes to offer an explanation of shifting patterns of governance. It shows how shifts in governance would most likely be biased in favour of the coalition that maintains hegemony through material capabilities, ideas and accompanying institutions. In a seminal contribution by Cox, this approach was extended to the international system.[125]

A drawback of this bundle of literature, however, is that it runs the risk of overemphasising the social relations of production as the determinant of interests (and hence reducing preferences to broader class relations).[126] At its crudest, such an economism is just as vulnerable as public choice approaches to the criticism of an uncontextualised derivation of abstract interests mentioned above. Furthermore, meticulously carving up classes into fractions of capital begs the question whether it would not be more useful to start our analysis from the actors and their perceived interests and move upwards from there.[127] Some sets of actors are clearly more successful in organizing collectively and articulating their interests.

The hegemony of a certain fraction of capital might account for the fact that all regulatory proposals are biased in its favour; however, that still leaves the question why one specific regulatory proposal is chosen from a range of possibilities. What influence does the policymaking process and the institutions actually have on the outcome? Many of the actual political struggles over market regulation – with important consequences for groups of citizens - run the risk of being underestimated in a neo-Gramscian analysis. While this approach might be

[120] Bieling & Jäger, 2009.
[121] Vacca, 1982.
[122] Gill & Law, 1993.
[123] Cox, 1981, p. 136.
[124] Cox, 1987, p. 26 - 28.
[125] Cox, 1987.
[126] Gamble, 1999, p. 143.
[127] See for a critique of 'fractionalising' classes: Clarke, 1978.

useful for analysing the grand thrusts of capitalism, it is more difficult to link it to actor-level empirical phenomena. In light of these drawbacks it seems preferable to look at the revealed preferences of actors in the policymaking process, and empirically derive their preferences instead of building our theories from the abstraction of dialectical relations between labour and capital and carving up these abstractions into actors with explanatory power. In short, neo-Gramscian approaches have managed to integrate the three explanatory factors, but in the process sacrificed attention to a range of interesting and important empirical phenomena.

This brings us back to the question how to combine the three explanatory factors in a coherent framework so as to maximise theoretical leverage that can be brought to bear on shifts in governance. We should first of all note that the material interests of the actors should be empirically derived through revealed preferences, as they are not constant. The interests of private actors (and public actors as well) are, for example, dependent on the specific market structure in which they operate and the competitive pressures it entails. There is no clear ex ante 'public interest' for state actors and not even a clear 'private interest' for private actors. Moreover, the position actors have and the way they interpret this material interest is based on the specific context or role actors play in policymaking institutions.

Different actors with different revealed preferences meet each other in policymaking institutions that are at least partially exclusionary. These institutions therefore play a role in shaping the process. However, the interaction within the policymaking institutions also feeds back into the preferences of actors: groupthink and skewed argument pools might shape their preferences. The policy community dealing with global financial governance is presented as an expert group, entrenching the notion that financial governance is technocratic and best left to independent institutions (e.g. central banks for monetary policy). This can lead to the de facto exclusion of actors from the policy community. If the group of experts establish a common problem definition that comes to dominate the policy community, this can narrow the range of possible developments regarding global financial governance because policy solutions that do not fit their problem definition and 'yardstick' are not seriously considered.[128] It is not without reason that many central banks have extensive research divisions and that private firms commission academic research or bundle their resources in the research divisions of business associations. In this way, a link emerges between certain material interests that use ideas to exclude other interests from the crucial policymaking institutions of the policy community.

As mentioned above, this link is reciprocal, however. A narrow policy community can influence the problem definition and yardstick by not allowing for extensive deliberation, but instead basing decisions on a skewed argument pool.[129] The articulation of preferences by actors becomes bound by groupthink and skewed argument pools, and while actors in the policymaking process

[128] As elaborated by Ikenberry, 1992.
[129] Baker, 2010.

can get their preferences satisfied by 'doing the intellectual work', this intellectual work also narrows the range of discussions and hence possible preferences being articulated.

We consequently have a model of the policymaking process where policymaking institutions and ideas play a constitutive role in shaping preferences, while vice versa preferences also play a role in determining the policymaking institutions that house the policy community and the ideas that get expressed in the process. To account for the policymaking process leading to shifting patterns of governance, we have to understand this interdependent dynamic between ideas, institutions and interests.

This model of the policymaking process leaves us with the question what the relation between the policymaking process and shifting patterns of governance and changing market structures might be. The next section will elaborate on this relation and builds towards a simultaneous explanation of shifts in governance patterns and changing market structures.

Addressing market structures and governance simultaneously

The previous section discussed the theoretical literature on policymaking processes in order to address the underspecification of this process in both Historical Institutionalism and New Institutional Economics. Inter alia both HI and NIE take a functionalist approach to policymaking (assuming stable preferences). However, as the discussion of policymaking processes above showed, there are feedback loops in the policymaking process itself that can shape preferences in important ways.

Building on the HI and NIE approaches with a model of the policymaking process does not necessarily address the drawback that both HI and NIE ultimately predict stability in the social world. An ossification of governance patterns takes place through various forms of path dependency, leading to the continued existence of distinct varieties of capitalism in globalised markets, for example. Olson has gone as far as to argue that this ossification of inefficient governance patterns inevitably leads to economic stagnation.[130] Change could result from 'breakpoints', for example as a consequence of financial crises. It follows that these theories address with difficulty continuous *shifts* in governance along our dimensions (as these would be rare).

Empirically, however, this stability cannot be found. There is a continuous dynamic of shifting patterns of governance in the global financial system, as well as changing market structures (as the preliminary discussion of the case studies has demonstrated). Shifts in governance along the three dimensions occur almost constantly in apparent relation to changes in the market, which is similarly also dynamic. Only by going into the extreme abstract ('some form of property rights' or 'some form of bank regulation') can we argue that there is stability

[130] Olson, 1982.

over time. However, in doing so sight is lost of changes on a less abstract level – changes which have important distributional (and hence political) consequences.

It will be argued in this section that the solution of this empirical challenge to HI and NIE lies in a different conceptualisation of the relation between states and markets. By simultaneously analysing developments in governance patterns and in market structures, it becomes clear that it are not so much financial crises that are the drivers of (fundamental) shifts in governance patterns, but that these crises are rather an expression of changes in market structures that drive shifts in governance. In elaborating this point, and in combination with the conceptualisation of the policymaking process above, the theoretical approach of this thesis is developed explaining the developments in the global financial system both on the front of governance and on the front of market structures.

NIE acknowledges that markets cannot function without (state) institutions or 'governance'. It explains the emergence of this pattern of governance as the result of market interaction, yet at the same time it seems that there is still a dichotomy between markets and states, with markets somehow emerging after which states are necessary to reduce transaction costs. It therefore fails to account for the apparent link between changes in market structures and shifts in governance patterns.

To push this argument further: many explanations of the dynamics of the global financial system portray political institutions (mistakenly) as an external intervention into market dynamics. There is an inherent notion of a dichotomy of states and markets. This dichotomous view of states and markets is reinforced by the separation of the disciplines of Economics and Political Science. To make a crude generalisation: it appears that Political Science has a bias towards states and government, seeing political economy from the perspective of the state, while Economics on the other hand has a bias towards private actors and market transactions, building theories about political economy from the perspective of the market. Empirically, however, market processes and public political authorities are never found apart.[131] The dichotomous view of states and markets hence makes no empirical sense.

Even as an analytical distinction, the state-market dichotomy blinds us to the ways in which states are active constituents of the market, and the ways in which market actors and their constituencies are part of the decision-making on and implementation of governance patterns.[132] The optimal form and level of governance may prove politically and socially unworkable, and the actual form and level of governance will not necessarily be determined by considerations of market efficiency. Within the policymaking process in which the governance of the global financial system is discussed, the central goal of the participants is not so much an optimal international allocation of resources as it is to further the (economic) interests of certain specific constituencies. To explain the dynamics of global financial governance,

[131] See e.g. Tilly, 1992; Fligstein, 2001; and Schwartz, 2010.
[132] Underhill, 2007b.

we should consequently look to explain the interrelated dynamics of changes in market structures and the political interactions constituting these markets.

What is often missing is the acknowledgement that actors (public and private) are simultaneously active in the market and in the policymaking process determining governance patterns. For private actors, the political and regulatory process at the (inter)national level is as much part of business strategies as is investment and marketing.[133] Assuming that the process of competition is somehow separate from the deployment of political resources by firms is empirically incorrect. Private actors themselves are not only interested in successful competition, but also in governance patterns that are beneficial to them. Krueger's original notion of rent seeking was mostly associated with developing countries' politics, as these supposedly had higher levels of political intervention in markets opening up possibilities for rent seeking.[134] However, there is no reason to assume that it is a phenomenon peculiar to developing countries. Firms simultaneously deploy their political and competitive resources to affect the pattern of competition, e.g. by establishing a favourable regulatory framework. This is captured by the wider notion of 'policy rent seeking' to express that firms across all markets seek to further their interests through lobbying for policies that favour their competitive position.[135]

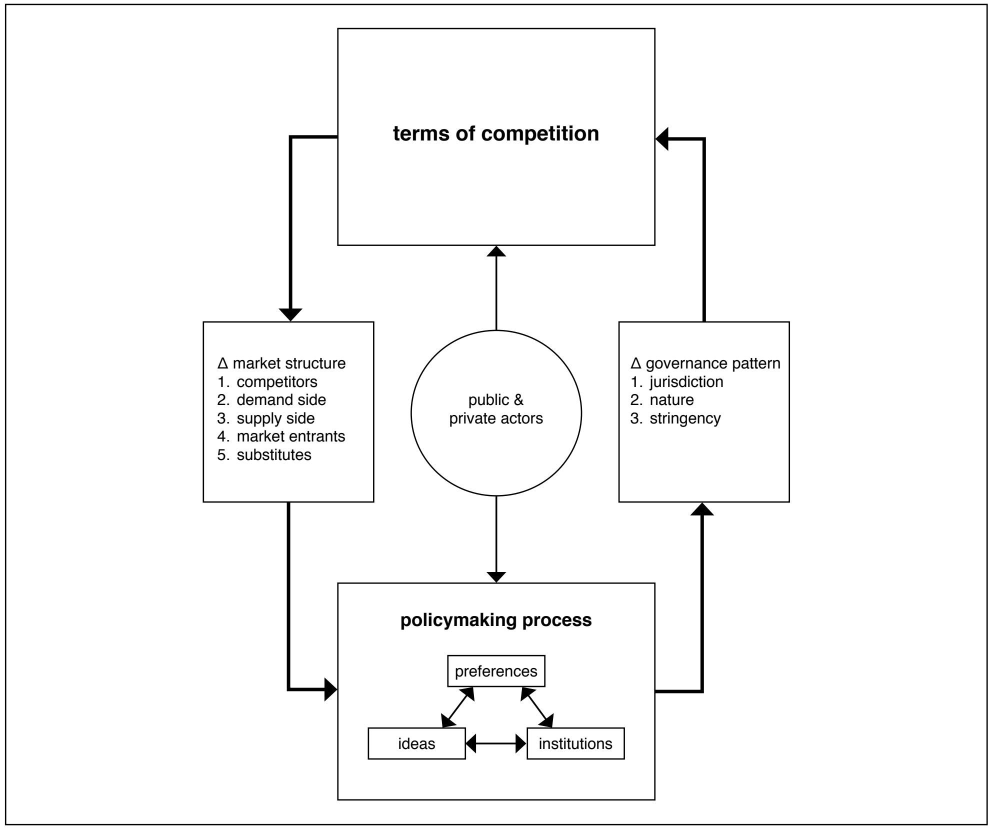
On the other hand, while public actors play an important role in the regulation of the global financial system, they are at the same time active as market participants (e.g. sourcing their financing needs from private financial institutions). Developments in the market structure (e.g. as a result of regulation) are consequently a prime concern for public authorities to ensure future funding on competitive terms. We should therefore not make a sharp distinction between interaction on markets leading to changing market structures and political action in policymaking processes leading to shifting patterns of governance. The actors are the same and their preferences are derived symbiotically from both market and political interaction.

In short, the dichotomous view of states and markets fails to elucidate the relationship between market structures and patterns of governance that is observable in the process of globalisation. The political dynamics in the policymaking process should be integrated into the notion of what a market is, together forming the (global) financial system. The policymaking process functions as the bridge between changes in market structures and shifting patterns of governance, creating a persistent feedback loop from shifting patterns of governance to changing market structures.

It is thus the policymaking process that functions as the crucial integrating link between changing market structures and shifts in governance, since on the part of private actors it is a part of their market activities and on the part of states it is an opportunity to advance constituencies' interests and safeguard their position as a market participant (e.g. when sourcing their financing needs from market parties). This creates a feedback loop between the outcome of policymaking processes (shifts in governance patterns) and changing preferences of actors regarding future governance patterns (which are fed back into policymaking processes). This feedback loop is driven by the fact that outcomes of policymaking processes change the terms of competition and thus also the structures of markets and their distributional outcomes (and resulting preferences for governance) in an ongoing fashion.

To summarise, the theoretical approach developed here leads to explanations of changes in global financial governance based on a combination of preferences, institutional contexts and ideational factors. Based on this combination, actors wage a political struggle in the policymaking process concerning global financial governance that determines the changes in jurisdiction, nature and stringency of governance. These changes alter the incentives and constraints for market actors (the terms of competition) and in such a way change the market structure. This change in market structure leads to new preferences for governance patterns from both public and private actors, feeding back into the policymaking process (and thereby completing the feedback loop, as illustrated in figure 2.1 below).

Figure 2.1. The relationship between shifting patterns of governance and changing market structures



[133] Underhill, 2003. See also Baron, 1995 arguing the same point from the perspective of business studies.
[134] Krueger, 1974.
[135] Underhill, 2010.

Of key importance are consequently the relationship and interaction between private and public actors in both market exchange and policymaking processes, as well as their implications. We can only understand the search for optimal patterns of governance by inductively looking at the preferences of the diverse range of public and private actors involved and how these interact and are transformed in the institutions of policymaking. This brings us back to the question of the relationship between political institutions of states and the institutions of the market in the international domain, and how it should be conceptualised. Here, the project aims to make a contribution to the theoretical debate by bringing the Economics and Political Economy literature closer together. The aim is to better understand the search for optimal patterns of governance in the context of the realities of power relationships among a diverse range of public and private actors.

The added value of this approach lies in its account of the continuous feedback loop between shifts in governance patterns and changing market structures driving the dynamics of the financial system. Each step in the feedback loop serves to form an important part of the explanation for the next. Changes in market structures are not as exogenous as some theories would lead us to believe; they are both a reaction to competition *and* the outcomes of the policymaking process. For example, the internationalisation of international financial markets was only possible because of the political decision to liberalise financial markets and open domestic capital accounts.[136] Subsequently, the emergence of international banks led to the need for a new vision on banking supervision elaborated in the first Basel Capital Accord. New market structures and institutions in which the policymaking process is focused lead to new preferences for governance patterns, feeding back into the policymaking process. The next section elaborates on this added value by summarising the arguments made in this thesis, both on a general level and with respect to the two case studies.

Argument

This section will first of all derive general propositions from the theoretical approach elaborated above. In the following two subsections, these theoretical propositions are 'operationalised' at the level of the case studies. In the final subsection, the propositions will be summarised and generalised (as well as discussed in relation to alternative explanations). Together, this works towards elaborating the central argument of this thesis.

Theoretical propositions

The discussion above already hinted at a number of propositions, distinct from rival accounts of the developments in governance patterns and market structures. Two main theoretical

[136] Helleiner, 1994.

propositions are presented. First, at the most general level, the research explores within the domain of financial governance the proposition that there is a symbiotic relationship between the changing structure of the market and shifting patters of governance. Changes in preferences concerning governance therefore appear intimately bound up with preferences concerning market structure: changes in markets generate changes in actor preferences concerning regulation and governance, and the outcome of conflict over divergent actor preferences concerning governance and regulation (the shifts in governance pattern) generates changes in market structures. This proposition consequently entails continuous change, which differs from propositions following from HI and NIE, which would predict more stability.

The second proposition states that public actors continue to wield crucial influence on the dynamics of the global financial system, even in the face of the huge growth of financial markets and its cross-border and cross-sector integration. The debate on states in globalised markets seems to be misguided by its implicit state-market dichotomy. As the discussion above showed, an integrated notion of changes in market structures and shifting patterns of governance points to the interaction between public and private actors as the main force behind changes in both market structure and governance pattern. Although the policymaking institutions might change, the continuing importance of (certain) public actors in producing or legitimating authoritative decisions regarding governance patterns does not. Public actors have an independent preference, linked to their position in the policymaking process *and* their role as market actor. They not only have a preference for maintaining a well-functioning market, but also for enhancing their own position in that market. While private actors might exert a strong influence on the policymaking process, their preferences regarding governance are shaped by previous decisions of private and public actors regarding governance patterns and their subsequent influence on the market structure. Also in that sense, public actors remain of continued relevance.

These propositions are further elaborated and linked to the case studies in the following two subsections. This means the propositions are 'operationalised' by showing how the theoretical approach accounts for shifts in governance across the three dimensions as well as changing market structures.

Explaining the success of the Basel Capital Accords

It will be argued that the emergence of the first Basel Capital Accord can be explained by the shifting preferences of US public and private actors that resulted from the changes in market structure put in the limelight by the Latin American debt crisis.[137] Where US public actors were eager to show themselves to be 'punishing' the banks with tougher supervisory standards, the US banks were eager to come to an international agreement on strengthened bank supervisory standards to level the competitive playing field. Due to a similar philosophy

[137] Compare Oatley & Nabors, 1998.

of banking regulation, the UK quickly latched on, and subsequently competitive concerns of banks that would potentially be excluded from these two largest banking markets led to enough pressure for a global agreement in the form of the Basel I Capital Accord.

It will be argued that this accord entailed a shift 'upwards' in the jurisdictional dimension. On the 'nature of governance' dimension, Basel I remained a characteristically 'public' pattern of governance. Stringency did increase as the Accord set an 8 per cent risk-weighted capital standard with fixed risk categories (relative to earlier national level governance patterns that had no formal capital requirements or less stringent standards).

This shift in governance, it will be argued, accounts for important changes in the market structure: the emergence of bigger, more diversified and highly internationalised banks with 'sophisticated' risk management practices. These banks for example increasingly engaged in securitisation of balance sheet items to reduce risks, thereby circumventing capital requirements. Due to the changes in market structures, preferences of the major banks shifted towards more market-oriented forms of governance. Public supervisors, on the other hand, realised the system was being gamed and that the risk management models of large internationalised banks needed to be addressed. These shifting preferences led to calls for a renegotiation of Basel I. Last, the shift in governance Basel I entailed also institutionalised the BCBS as the main policymaking institution. The BCBS functions as a policy community where private sector influence combines with an exclusionary group of public actors with strong interests in a thriving and open financial sector.

It will be argued that the shifted preferences and the institutionalisation of the policymaking process in the BCBS explain the subsequent outcome of the negotiations on Basel II: a shift towards less stringent, market-based forms of governance. The most advanced international banks are allowed to use their own internal risk models. This arguably also shifted the nature of governance towards more private forms, although the final check remains with the (public) banking supervisor. These changes were in accordance with the preference for market-based forms of governance of the main actors in the policy community. However, the specific shifts in governance can be explained by (1) the policymaking institution, which consists of public actors of the G10 countries and is very open to influence from large international private financial institutions; and (2) the conflict in preferences between these two groups of actors, with the public actors striving for an intellectually rigorous governance pattern (a comprehensive risk-weighted standard) and the private sector aiming for market-based patterns of governance.

It will be shown that the explanation this account offers of the developments in banking supervision is superior to explanations solely based on ideational factors (e.g. Kette's claim of learning effects[138]). These explanations fail to acknowledge the fact that the preferences of internationalised banks were satisfied over the preferences of, for example, smaller regional

[138] Kette, 2009.

banks. This means that the 'ideas' underpinning the Basel II Accord are not neutral. The same argument applies to functionalist explanations seeing Basel II as a response to globalisation as these do not account for the shifts towards market-based forms of governance.[139]

Explaining the failure of the SDRM

The sovereign debt crisis resolution case study starts with a similar dynamic as the bank capital adequacy standards case study. It will be argued that a shift in preferences of US public and private actors as a result of the Latin American debt crisis is the starting point to explain the patterns of governance for sovereign debt crisis resolution in the 1980s. US authorities took the lead in designing an ad hoc governance pattern in the form of the Baker and Brady plans. The central position of the US (both in terms of affected banks as in terms of voting weight in the IMF) allowed it to satisfy its preferences for these governance patterns, which it shared with private actors. The US was followed (sometimes reluctantly) by the European state agencies.

It will be argued that these ad hoc plans entailed a shift 'upwards' in the jurisdictional dimension of governance to the international level (not global, as the plans had no universal applicability). With respect to the 'nature' dimension of the plans, they were 'public', designed and implemented by state agencies and the IMF. The stringency of the governance pattern under the Baker and Brady plans differed for different actors. Debtor states were restrained by stringent conditionality, while private actors were steered in a much less stringent way towards co-financing of the IMF programmes and voluntary debt restructuring.

It will subsequently be argued that especially the Brady plan had an impact on the market structure by encouraging the growth of the secondary market for sovereign market debts in particular, and capital market financing of emerging markets in general. This diversification of the market explains the subsequent lack of progress in this policy domain as there were no leading actors with clear preferences for shifts in governance while the Brady plan was case-specific to address the Latin American debt crisis. Only after the East Asian crisis did a significant realignment of preferences take place.

Public actors developed a preference for better mechanisms to deal with sovereign debt crises in the face of mounting costs of official refinancing. This allowed the IMF to gain the initiative after the East Asian crisis as not only the prime policymaking institution but also a leading public actor proposing a new governance pattern. It will be argued that the preference of the IMF for a global level governance pattern in the form of an SDRM was based on economic analysis of market failures, and went against the perceived interests of private actors. It hence enticed a strong backlash by both some public national level actors and private sector actors. This led the major policy proposal for a global level public governance mechanism to be defeated by a coalition of private sector interests and debtor states.

[139] Kapstein, 1994 makes such an argument for the emergence of Basel I.

The result of this policymaking process is a shift upwards on the jurisdictional dimension in the form of a global level standard for CACs and the 'Principles for Stable Capital Flows'. These proposals are respectively of a mixed public/private and private nature (while the CAC standard is public, implementation of CACs is done by market actors). Compared to the Brady plan, this consequently entails a shift towards more private forms of governance. The new governance pattern is less stringent than the Baker and Brady plans (and definitely less stringent than the SDRM).

Summary and generalisation in comparison to alternative explanations

There seem to be interesting parallels between the cases. For both cases, the changing market structures ('globalisation of the financial system', reflected in bigger, international banks and increased capital market financing of emerging markets) have shifted the interests of actors and led to the emergence of global level policymaking institutions with a high degree of involvement of private actors. It will be argued that these developments facilitated the shift from international level public governance to global level private sector self-regulation. It will also be argued that this shows that the policymaking process cannot be explained by taking a state-centred perspective, but that market developments and private actors need to be included in the equation. At the same time it shows that the simultaneous globalisation of the financial system and the development of new forms of multilevel governance is not an autonomous and exogenous development.

In other words, in both cases we seem to see a dynamic where shifts in governance and changes in market structure occur simultaneously, through the interaction of public and private actors in the policymaking process and in market competition. Basel I contributed to the emergence of diversified and international banks with sophisticated risk management practices. This shifted private actor preferences towards the use of in-house risk models. Public actors followed this preference as they witnessed that this new market structure allowed for the 'gaming' of Basel I with the associated increases in risks. These shifting preferences led to the renegotiation of Basel I to Basel II. In the case of sovereign debt crisis resolution, the Brady plan encouraged capital market financing of emerging markets. This diversified the preferences of private actors and led to a reduced sense of urgency to make progress on this issue. At the same time, public actors (specifically the IMF) acknowledged the potential risks and proposed a comprehensive approach to deal with the issue. This was defeated by the strong involvement of private actors in the policymaking process and the lack of support among debtor nations. In short, both cases show the feedback loop posited by our theoretical model, and both cases exhibit the predicted change instead of stability.

Both cases also show that public actors' preferences reflected both an 'theoretical' understanding of how markets should function and their own market position (e.g. as borrower or provider of official refinancing). These public actor preferences complemented private actor demands (e.g. including operational risk issue in the Basel Capital Accord or the emergence of a standard for CACs). This research will thus show that it is state and private actors in collusion that drive this process. There is consequently no retreat of the state; at best there is a shift in the power balance between different public actors on the national or international level.

A final point which will be made is that the relatively closed nature of the policymaking community leads to questions of legitimacy and accountability. In both cases, the input legitimacy of the policymaking process can be questioned. Furthermore, the closed nature of the negotiations makes it difficult for elected representatives to hold the policymakers accountable. What's more, this problem is compounded by the role of the private sector. In the emerging global level policymaking institutions, private sector representatives are strongly embedded and are able to accommodate their interests better than those of outsiders to the policy community (for example parliamentarians or CSOs). The increasing importance of governance institutions at the global level has not been accompanied by significant measures aimed at improving accountability and legitimacy of this level.

Research methodology

After laying out the main arguments in the previous section, it is time to turn to the research methodology. To recap, the research questions are: (1) How has the pattern of governance shifted in the two policy domains of bank capital adequacy standards and sovereign debt crisis resolution over the period 1980 - 2005? How have the relevant market structures changed over the same period?; (2) What are the characteristics of the policymaking process leading to these shifts in the pattern of governance of the two policy domains in global financial governance?; and (3) What is the role of the policymaking process in both shifts in governance and changes in market structure? In short, how do shifting patterns of governance relate to changes in market structures? These questions will be addressed by a qualitative analysis of two case studies, backed up by quantitative data where relevant. The case studies – concerning bank capital adequacy standards and sovereign debt crisis resolution – are selected from the field of financial governance.

There are several reasons why a qualitative case study design offers the most leverage over the research questions. Qualitative case studies offer the possibility to trace the evolution of the global financial system and the historical development of the policymaking process. They will consequently map the relationship between changes in market structures and shifting patterns of governance. In other words, the long-term perspective taken in the case studies allows analysis of the changes in the jurisdiction, nature and stringency of the patterns of governance in the respective fields, and of the relationship between the associated policymaking process and the resulting changes in patterns of governance. The evolution of the interaction between these two elements of the main research questions does not occur overnight, and hence needs careful process tracing, which case studies allow.

Each individual case can consequently be examined in sufficient depth to produce a rich account of the changes. Moreover, by using case studies a nuanced classification of the actors involved can be developed showing how public and private actors interact and how in their interactions the distinction can become less clear-cut (states acting as market actors and market actors implementing governance).[140] The historical and rich account of qualitative case studies will allow for an exposition on how market dynamics shifted preferences leading to demands for shifts in governance (the feedback loop elaborated above) and will allow for the consideration (and rejection) of alternative explanations as mentioned in the argument section above. This therefore makes this an appropriate design for the testing of the propositions. In the next subsection, the selection of the two case studies will be discussed. The second subsection deals with the data sources.

Case selection

To address the research questions two policy domains in the realm of global financial governance are studied, on the one hand the policies regarding bank capital adequacy standards, and on the other the policies regarding the resolution of sovereign debt crises. The case study selection strategy aimed to locate variation in the shifts across the three dimensions of governance, in other words a 'diverse case method'.[141] Before elaborating this strategy, it should be noted that both case studies also have a significant time span. Both cases have been important policy domains for an extended period and are therefore very well suited: the negotiations on the first Basel Accord started in the early 1980s, while the issue of sovereign debt restructurings gained traction following the 1982 Latin American debt crisis. This longer history is also a reflection of the fact that these two policy domains are important enough to warrant continuing attention from policymakers.

Importantly, each policy domain had its own independent dynamic, making for two diverse case studies. Where in the case of banking supervision the renegotiation of the first Basel Capital Accord was championed by the private sector, the most important initiatives in the field of sovereign debt crisis resolution came from the public sector, notably the IMF. While the case of banking supervision concerned the revision of a global public-based governance regime, sovereign debt crisis resolution concerned a state level market-based regime. Interestingly, the policymaking process in the banking supervision case came to a successful conclusion, while in the sovereign debt crisis case the most important policy proposals were not implemented. Instead, private sector initiatives like the 'Principles for Stable Capital Flows' filled the vacuum. Both cases also show variation over time in the third dimension of governance, the stringency of regulation. The Basel Capital Accords explicitly shifted from

[140] Next to these substantial reasons for using a small-n design, as a practical matter it is also doubtful whether the universe of cases could be reasonably expanded to facilitate a large-n approach. As the research concerns the global financial system, the number of cases in financial governance is relatively small. There are some other policy domains with the necessary temporal development and global dimension (e.g. accounting standards) but not many.

[141] Seawright & Gerring, 2008; Gerring, 2006. Flyvbjerg, 2006 refers to this as selecting 'maximum variation cases'.

a specific (and perhaps arbitrary) norm to a market-based approach based on banks' own practices. The governance pattern for sovereign debt restructurings arguably shifted from no regulation to limited, market-based forms. Because of this variation in the case studies, they form a more stringent test of the proposed feedback loop than a single case study would: can the same model explain both outcomes?

The selected case studies have the benefit that important actors overlap, e.g. ministries of finance, central banks and internationalised private banks. This makes the policymaking processes and changes in market structures arguably more comparable, despite the variation in developments. It can consequently show how the same sets of interests work in distinct policy domains. This is the benefit of choosing these two case studies over other available cases (for example, European capital market integration or accounting standards),[142] where a number of different actors are involved. Yet, there is no reason to assume the cases are not representative of the broader universe of policy domains in global financial governance. Perhaps this is best illustrated by the fact that several other policy domains are also discussed in the main policymaking institutions of these cases (e.g. the IMF as a focal point of global efforts in increasing financial market transparency[143]). By using this dual case study design, the external validity of general claims derived from both case studies increases. A comparison of the historical developments in both cases will increase the validity of more general claims made about developments in global financial governance.

The aforementioned underscores that the case selection strategy was based on two concerns. On the one hand the general propositions are tested on a cross-case basis, whereby the preliminary analysis suggests the Basel case shows success in the emergence of a global level public pattern of governance and the sovereign debt restructuring case shows the failure of proposals for a similar global level public pattern of governance. On the other hand, each case has enough variation within the different dimensions over the time span of the cases to allow internal case comparisons of the case-specific propositions.

Data sources

The propositions will be held against three main data sources: documentary sources, semi-structured interviews and industry statistics. This variety of sources increases the validity and reliability of the claims based on them, since it allows for cross-validation between various sources ('triangulation').

The documentary sources consist of a range of publications and archive materials. Firstly, the press coverage of two leading outlets in the field (the *Financial Times* and the *Economist*) was collected using relevant key words. The key words were based on general characteristics of the cases (banking supervision, sovereign debt crises) and contemporary references in the

[142] For the former, see Mügge, 2010; for the latter, see Perry and Nölke, 2006.

[143] Walter, 2008.

articles resulting from the search based on general characteristics (e.g. Third World debt crisis for what is now known as the Latin American debt crisis). These two publications have regularly followed the negotiations and often provide interview data with policymakers at the time of the negotiations. The collected newspaper articles will show how the policymaking process developed (at least according to analysts of the time). A second documentary source is composed of official publications, for example reports by the relevant international organisations (IMF, BIS), communiqués of international meetings and policy statements of actors in the policymaking process. These documents demonstrate actors' preferences in the negotiations as well as document the outcomes (in terms of the shifts along the dimensions of governance). The third documentary source was the archives of the IMF (and to a lesser extent, the BIS). These documents will complement the previous two document sources by providing minutes and background documents used in closed-door negotiations. These internal documents also show more about the actors' strategies during the negotiations, while the aforementioned publications like position statements mostly deal with the content of the negotiations. Again, this will provide insights into the actual dynamics of the policymaking process, and can also function as a check on the recollection of the interviewees.

The second data source consists of semi-structured interviews with official and private sector representatives. These interviews to a large extent conformed with the notion of elite interviews of Dexter (1970) in that there was a lot of attention to the interviewees' definition of the situation and account of the policymaking process.[144] Typically, the questions concerned the interviewees' background and organisational embedding (e.g. 'how do you develop your policy position within the organisation?'), the interviewees' view of global financial governance ('what are the most important policy issues you face?') and more specific questions on the case studies ('how did the negotiations on Basel II evolve?'). A conscious effort was made to interview policymakers from various backgrounds as regards both nationality and affiliation (financial firms, public sector and CSOs) and to corroborate stories from the document sources or different interviewees.

The interview data was used to obtain a complete picture of the actual dynamics in the policymaking process. The positions of the actors in the policymaking process are developed, influenced and advocated through direct interactions that are often closed-door negotiating sessions. As a consequence interviews with the actual participants are necessary to gauge the dynamics of the policymaking process. This gives leverage on the question of the interaction of interests, ideas and institutions in the policymaking process. The interviews consequently work towards an explanation of the dynamics of the policymaking process and the resulting shifts in governance across the different dimensions.

The third data source is composed of industry statistics for the global financial system. For example, the OECD, BIS and IMF collect many relevant data series for a wide range of countries.

[144] Dexter, 2006, p. 18.

Furthermore, industry associations and individual bank reports provide valuable data. This quantitative data provides insight into the changes in market structure and is linked with the interview and document data to account for the interaction between changing market structures, shifting preferences and the policymaking process.

To sum up, the research design elaborated above allows me to answer the research questions through the historicised approach of qualitative case studies building on several independent data sources. Although each of the data sources has its own problems regarding reliability and representativeness, combining the three in triangulation overcomes these potential problems and increases the validity of my account of the process.

In the following empirical chapters, the approach developed above will be applied to the cases of bank capital adequacy standards and the resolution of sovereign debt crises. It will be shown that over the course of the 1980s and 1990s a transnational policy community based in global level policymaking institutions emerged that combined specific material interests (closely related to the private sector) with a shared view on preferred solutions (addressing market failures by market-based rules and procedures). This policy community not only resulted from the internationalisation of the financial sector, but also gave impetus to further changes in the market structure of the global financial system (such as further internationalisation and financial integration). But before delving into the cases, in the next chapter the stage is set by describing the historical background to the case studies. This next chapter will also discuss wider developments in the global financial system that are of relevance to the case studies.

Chapter 3

Setting the stage: financial market trends and institutions

In this chapter, the dynamics of the global financial system post-World War II is sketched in broad strokes in relation to the conceptual approach developed in this thesis. Relevant developments in the market structure and in the patterns of governance will be discussed, as well as the interplay between the two. The focus lies on the banking market and the market for sovereign credit, and attention will be paid to the actors (and their preferences), the ideas and the policymaking institutions that have emerged or continued to be of relevance in the period of the case studies (roughly 1980 – 2005). Doing so will 'set the stage' for the detailed case studies in the following two chapters. More specifically, this chapter serves three purposes.

First, this chapter will introduce the principal policymaking institutions and actors that played a role in the post-war period. Their history, membership and decision-making procedures will be discussed to obtain insight into their preference formulation (actors) or the impact they had on the shaping of the policymaking process (institutions). Many of the policymaking institutions and actors that play important roles in the case studies were already established before the 1980s and continue to be important to this day. This chapter will also introduce new institutions and actors that emerged in the period covered by the case studies.

The second purpose of this chapter has already been mentioned above: to set the stage for the case studies. It will illustrate the prevailing governance patterns and market structures as they were at the beginning of the case studies, and will discuss how they have come into being. In the previous chapter, a continuous feedback loop between shifting patterns of governance and changes in market structures was developed. To understand the point of departure for the case studies (at which point do we 'step into the loop'), this chapter sketches the dynamics during the post-war period up to and including the 1980s, providing the groundwork for the subsequent case study chapters to build on in more detail.

A third purpose of this chapter is to contextualise the developments over the period of the case studies, indicating where they deviate from or correspond to broader dynamics in the global financial system. This serves to aid an assessment of the generalisability of the inferences drawn from the case studies and demonstrates the wider applicability of the feedback loop developed in this thesis.

For the sake of presentation, the dynamics in the global financial system are divided into three episodes, although in reality the course of events flowed more continuously through these periods than the section breaks suggest. The first episode, ranging from 1945 to 1971, is defined by the Bretton Woods monetary system and its accompanying financial order (in short 'Bretton Woods'). This was a system of fixed exchange rates based on a gold-dollar standard and curtailed international finance to the benefit of national policy autonomy and national varieties of capitalism. At the apex of the system stood the IMF with its sister institution the World Bank. As the discussion will show, however, the repression of (international) financial markets did not last long. For a variety of reasons, often resulting from the specific set-up of the Bretton Woods governance pattern, a new international financial market emerged in the form of the so-called Euromarkets. The emergence and growth of the Euromarkets had a significant impact on the prevailing, nationally oriented market structures and in combination with the internal contradictions of the gold-dollar standard to a large extent explain the collapse of the system in the early 1970s.

The end of the Bretton Woods system hailed the beginning of the second episode distinguished in this chapter, which lasted from 1971 to 1982. This episode was marked by the rebalancing of forces in the global financial system in response to the new set of incentives offered by the new reality of flexible exchange rates. With the financial repression and relatively stringent national regulations of the Bretton Woods governance pattern gone, both market actors and public actors were in search of a new way of doing business; in other words, they had to adjust to the new and rapidly changing terms of competition. Market structures altered significantly, while private financial actors also experienced the downsides of the less restrictive, more market-based governance pattern: exchange rate volatility posed a new challenge to be reckoned with. The IMF was in search of a new mission in this world of flexible exchange rates, while the Bank for International Settlements (BIS) made a comeback as a leading global policymaking institution. At the same time, financial globalisation intensified, for example shown by a large increase in private sector lending to emerging markets.

The third episode starts with the threat of default made by Mexico in 1982. This triggered a wave of similar declarations by emerging markets and came to be known as the Latin American debt crisis (then called the Third World debt crisis). The events of the 1980s gave both the IMF and the BIS a strong sense of purpose in the post-Bretton Woods world, and also led to the emergence of a private sector counterpart to these global policymaking institutions: the Institute of International Finance (IIF). Financial globalisation consolidated and expanded its reach (the political-economic dimension of this trend has been labelled 'financialisation'[1]). Moreover, amongst the internationalised elite of policymakers a consensus seemed to emerge in favour of this further expansion of financial globalisation and arguments were raised in support of liberal capital accounts, lowering existing barriers between financial sectors and

[1] See Engelen, 2008 for a discussion of the concept of financialisation.

reducing 'financial repression' (especially in emerging markets).[2] Both in response to this ideology and the new global financial market structure (accompanied by regular emerging market crises), a new market-oriented governance pattern started to emerge.

The chapter is organised in three sections corresponding to the three episodes introduced above. The discussion will on occasion deviate somewhat from this chronological order when relevant actors and policymaking institutions are discussed. A fourth and final section summarises two common threads, which can be distilled from the overview of the three episodes: the international expansion of the financial system (financialisation) and the variety of responses it evoked in the context of multilevel governance. The discussion of these common threads will also show how this historical 'background' analysis contributes to the answering of the research questions.

The rise of the Euromarkets and the fall of Bretton Woods: 1945 - 1971

The governance pattern of the international financial system after the Second World War was determined by the Bretton Woods monetary system and accompanying financial order. Negotiations on the post-war monetary and financial order had already started during the Second World War with the US and the UK as the main actors. The heads of delegation of these countries are seen as the architects of the Bretton Woods system: Harry Dexter White of the US and John Maynard Keynes on the side of the UK.[3] Both men were keen to reap the benefits of international trade while preventing the sorts of destabilising short-term volatility that was one of the causes of the Great Depression. Public actors (states) wanted the system to ensure that the social disruption caused by the Great Depression would never happen again. Therefore, the relatively liberal pre-depression financial order was discarded, and a new pattern of governance was set up that explicitly granted states the right to control capital flows (and indeed encouraged states to do so).[4]

The Bretton Woods system was characterised by fixed exchange rates with the gold-dollar peg as an anchor. It was, on the one hand, multilateral in nature, since it was based on an international agreement (and overseen by an international organisation, the IMF) and aimed to promote international trade. On the other hand, the system emphasised domestic social stability. The controls on capital flows allowed states to withstand their possibly disruptive effects, and gave them more leeway in pursuing macroeconomic and social policies (e.g. elaborated welfare states). This combination of trade liberalisation and domestic policy

2 Often labelled 'neoliberalism' or more specifically the 'Washington Consensus' (Williamson, 1990).
3 See for example Boughton, 2002.
4 Helleiner, 1994, chapter 2. See also De Cecco, 1979 showing how originally more radical proposals concerning capital controls by both White and Keynes were watered down in the subsequent negotiations.

autonomy has famously been dubbed 'embedded liberalism' by Ruggie.[5]

The institutional embodiments of the Bretton Woods system were two 'sister' institutions, the IMF and the World Bank.[6] The IMF was formally established in December 1945 with the founding 29 member states signing the Articles of Agreement.[7] Although the Soviets had been involved in the negotiations, the USSR and most states of the Soviet bloc did not join. Since decolonisation and the end of the Cold War, membership of the Fund has expanded to include almost all states and the IMF currently has 187 members. The original mandate of the Fund was: to monitor and discourage restrictions on the current account of the balance of payments; to deal with temporary balance of payments imbalances by providing temporary financing; and to oversee adjustments in the par rates of the fixed exchange rate system in case of fundamental balance of payments disequilibria.[8]

Voting weights in the Fund are determined by so-called quotas, i.e. the financial stakes of the member states in the Fund. These quotas were distributed according to the relative weight of the member states in the world economy at the time of the Fund's establishment. Quota changes need to be agreed on by an 85 per cent supermajority, and are often delayed or blocked by countries that would lose out due to their declined weight in the world economy. As a consequence, voting weights in the Fund only slowly adjust to new economic realities, leaving rising economic powers under-represented in the policymaking process. The US currently has just under 17 per cent of the vote, giving it a veto over changes in the Articles of Agreement and other significant decisions for which a supermajority is needed.

The IMF is governed by the Board of Governors, consisting mainly of central bank presidents or finance ministers of the member states. The Board of Governors is advised by the International Monetary and Financial Committee (IMFC), which mirrors at the governors' level its day-to-day decision-making body: the Executive Board.[9] The Executive Board currently has 24 seats, of which five are allocated to the biggest creditors of the Fund (at the moment in order of voting weight: the US, the UK, France, Germany and Japan). The other seats are allocated by elections to single countries (currently China, Saudi Arabia and Russia) or country groups (constituencies). Again, within the day-to-day decision-making body of the IMF – the Executive Board – this translates into a bias towards Western countries, which

5 The concept of embedded liberalism was introduced by Polanyi, 2001(1944) and applied to the Bretton Woods context by Ruggie, 1982.
6 As the World Bank was mainly involved in long-term lending for post-war reconstruction and development, it is less relevant for the case studies in this thesis and will not be further discussed here.
7 The following factual information on the IMF membership, staff, etc. is from www.imf.org (accessed March 2011).
8 Pauly, 1997, p. 81.
9 Although the International Monetary and Financial Committee did not have that name yet, but was earlier called the Interim Committee, in general references to this policymaking institution the IMFC abbreviation will be used.

hold relatively many seats. This under-representation of emerging markets has only recently begun to change.[10]

The original mandate of the Fund has evolved into three core contemporary tasks: (1) financing temporary balance of payments deficits; (2) surveillance; and (3) technical assistance.[11] To accomplish these tasks, the Fund has a permanent staff of around 2400, about half of whom are (macro)economists (often having obtained their PhD degrees from American universities).[12] These contemporary tasks underscore the importance of the IMF for the case studies. First, with respect to the governance of sovereign debt crisis resolution, the IMF is usually an important provider of financing to countries in crisis. The Fund's financing role is officially aimed at countries with a temporary balance of payments deficit, i.e. countries in a liquidity crisis, in a manner of speaking. However, as has been noted already, it is difficult to make the distinction between a liquidity and solvency crisis. As such, the Fund de facto plays a crucial role in determining the balance between official refinancing, domestic adjustment and private creditor restructuring. This is even more so because of the 'conditionality' the IMF attaches to its loans, which determines the domestic adjustment a country has to undergo.

With respect to the case of bank capital adequacy standards, the IMF is mostly involved through its surveillance (and technical assistance) task. This works on two levels: the Fund provides a general push for liberalising financial markets in its so-called Article IV surveillance of member countries[13] (see also the discussion of the Washington Consensus below). On a more hands-on level, the Fund is involved in the implementation of financial supervision in member countries under its Financial Sector Assessment Programme (FSAP). As part of the FSAP programme it assesses, for example, the implementation by member states of the Basel Core Principles of Sound Banking Supervision. Since the normative framework of the Fund's economic policies is rooted in neoclassical economics and the Anglo-Saxon variety of capitalism, this has been a constant source of pressure on countries to liberalise their financial sector and implement 'sophisticated' supervisory techniques like Basel II.[14] The IMF's surveillance can be augmented by its third main task, technical assistance. Through its technical assistance programmes the Fund 'trains' officials of developing countries in macroeconomic and financial policy. To sum up, the IMF is not only one of the central policymaking institutions – with a strong bias towards Western interests – it is also an important actor in its own

[10] See Underhill & Zhang, 2010 for a discussion of the normative underpinnings of these voting weights; and Underhill, Blom and Mügge, 2010a for an elaboration of the broader implications of these skewed voting weights in the IMF and the global financial architecture in general.

[11] See Schilperoort, 2010 for an overview of the role and responsibilities of the Fund, also in light of the current crisis.

[12] An IMF recruiter once boasted to me that the IMF employs the largest concentration of postgraduate degree macroeconomists in the world.

[13] An important element of the Articles of Agreement, which was later to become Article IV, obliged countries to cooperate with the Fund and its members to assure orderly exchange arrangements and to promote a stable system of exchange rates.

[14] See Pauly, 1994 on the normative underpinnings of Fund surveillance. Pauly, 1997 provides a broader analysis of the role of multilateral surveillance in the world economy.

right due to its financing and surveillance role. It has an important normative function in the spread of economic policies (including with respect to the supervision of banks).

The Bretton Woods system as originally envisaged entailed a shift in governance upwards on the jurisdictional dimension, exemplified by the central role of the multilateral IMF. It should be noted, however, that in practice the Fund played a more limited role than was foreseen at Bretton Woods. Monetary governance was more nationally based than Keynes and White had hoped.[15] Bretton Woods was a governance pattern of a public nature, with an international organisation with state membership in control. On the stringency dimension, it was constraining for both states and private actors. States would – by agreement – be constrained in their exchange rate policy (as exchange rates would be fixed), and they would be monitored by the IMF. It must be noted, however, that while the IMF currently looks at the full range of macroeconomic and financial policies of a country, during the Bretton Woods period it was much more confined to monetary and exchange rate policy.[16] The controls on capital flows meant that governance was also stringent on private actors. Generalisations about the shifts in financial governance that Bretton Woods entailed are more difficult, as domestic patterns of financial governance prevailed.[17]

The fact that the governance of the financial system was to a large extent a matter for national authorities had important consequences. In order to understand this, let us first turn our attention to the UK. For the British, Bretton Woods entailed more than just the shifts in governance mentioned above. It also meant the institutionalisation of their loss of monetary and financial hegemony to the US. No longer was Sterling – and hence London – the centre of the global financial system. With the advent of a gold-dollar standard (a de facto key currency system), that role had been allocated to the dollar and hence Wall Street. However, British public and private actors alike had an interest in maintaining the global role of London as a financial centre. Furthermore, the Bank of England (BoE) and Treasury were still enmeshed in decision-making institutions shared with City interests.[18] When the British banks found a 'loophole' in British restrictions in 1957 with respect to the use of Sterling loans to non-Sterling area countries (they could use dollar loans instead), these colliding preferences and smoothly functioning policymaking institutions sowed the seeds of what later became the Eurodollar (and more broadly, Eurocurrency) markets.[19]

[15] Strange, 1976, chapter 2.

[16] Pauly, 1997, chapter 5.

[17] In line with Keynes' dictum "Ideas, knowledge, science, hospitality, travel – these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible, and, above all, let finance be primarily national" (Keynes, 1933, p. 755 - 769).

[18] Burn, 1999, p. 228.

[19] Burn, 1999 refers to this as the 'governance of regulatory space' pointing to the combination of City bankers' innovations and UK authorities' deregulatory moves.

The development of the Euromarkets under the Bretton Woods governance pattern is as much a story of market forces resulting from the Bretton Woods system as it is of policy (non-)decisions by especially the American and British authorities.[20] Before elaborating on these, it should first of all be noted that innovations in information and communications technology played a role by facilitating rapid international financial transactions. Although these innovations are sometimes credited with an autonomous causal power, the Bretton Woods financial order was, as mentioned earlier, aimed at keeping finance domestic. This factor in itself could consequently only be a necessary but not sufficient condition.[21] In addition to the technological innovations, there was also a demand-pull emanating from multinational corporations (MNCs). As manufacturing firms internationalised, they wanted to retain their financial services providers. This consequently created a demand for international representation by banks.[22]

As mentioned above, the British financial policymaking community played an important role in enabling the Euromarkets. After the initial emergence of the Eurodollar markets, British policymakers, for example, changed regulations to allow foreign securities denominated in foreign currencies to be issued on the London Exchange (a 1962 decision that led to the emergence of the Eurobond market).[23] In general, the attraction of the British markets was what later became known as its arm's-length and principles-based supervision, where supervisors resorted to informal agreements and understandings rather than of legal sanctions.[24]

To account for the subsequent explosion of the Euromarket (see table 3.1 below), the developments in the US were key. As the dominant financial power it could not but play an important role in the development of the Euromarkets, and the specific combination of market forces and governance pattern in the US resulted in it doing exactly that. On the market side, the global market for dollars played a central role. This was a result of the monetary imperatives for the key currency in the Bretton Woods system, what has become known as the Triffin dilemma.[25] This dilemma concerns the trade-off between increasing liquidity required by a growing world economy and the relatively fixed amount of gold reserves. To supply the growing demand for dollars abroad due to the growing world economy, the US should run persistent current account deficits. This would lead to domestic deflation and in the longer run economic stagnation. The alternative was to supply the demand for dollars with printing new dollars. The latter, however, would undermine the confidence in the fixed dollar-gold link: the amount of dollars would grow without being matched by increases in US gold reserves. The Triffin dilemma is essentially a political trade-off between domestic interests in the monetary anchor state (the US) and the interests of a stable international system.

The US did indeed run persistent and deteriorating current account deficits in the 1960s.[26] To pre-empt the Triffin dilemma, the US financial authorities had a preference for controlling the outflow of capital.[27] They tried to stem the dollar outflow in the form of credits from the US through two main pieces of legislation: the Interest Equalization Tax (IET) and the Voluntary Foreign Credit Restraint (VFCR) programme. As will become clear below, the unintended consequence of this legislation was to encourage the growth of the Euromarkets.

The IET was installed in 1963 and entailed a tax on capital raised in the US capital markets by foreign actors. It consequently increased the cost of borrowing in the US for foreigners. Initially, it was not as such aimed at commercial banks, but rather at capital market intermediaries acting on foreign companies' behalf. It was a market-oriented capital restriction, since it changed the incentives for actors without directly intervening in the market.[28] Because of the lack of improvement in the American balance of payments position, it was extended to bank loans in 1965.[29]

The VFCR was established in 1965 and was more directly aimed at commercial banks' outflows. Although 'voluntary', banks not adhering to the credit restraint were held to account by the Federal Reserve. Banks initially lobbied against the different restrictions – mainly through the Bankers Association for Foreign Trade – but with little success. Lobbying then turned towards levelling the playing field, both vis-à-vis foreign competitors and vis-à-vis different classes of American banks (e.g. by making sure small banks also had access to the Euromarket circumventions).[30]

At first sight, the stringent regulations of dollar outflows seem in line with authoritative public governance to fulfil the monetary preferences of the Fed and Treasury. However, a closer look reveals a different pattern. Although direct private lobbying to prevent the restrictions from being adopted came to nothing,[31] the IET contained a loophole in the sense that foreign branches of US banks could roll over short-term loans indefinitely without incurring the tax. This encouraged Euromarket activity, specifically the development of the Eurobond market.[32] In 1967 the US government responded to this loophole by waiving the IET for loans by foreign branches, in effect sanctioning the existing practice. The VFCR also was not applied to lending from foreign branches, but only restricted lending from the US. As a result, although

[20] See, for example, Helleiner, 1994, chapter 4 and Strange, 1986, chapter 2 on the role of decisions and non-decisions in the emergence of the Euromarkets. In addition to the factors playing a role in the development of the Euromarkets discussed here, Kindleberger, 1993, p. 439 offers a more prosaic explanation: the simple convenience for Europeans of being able to trade in dollars during European office hours. Dale, 1984, p. 9 furthermore points to the role of the Communist states: these sought a safe haven for their dollar holdings that was not under American control.
[21] Strange, 1976, p. 178.
[22] Strange, 1976.
[23] Helleiner, 1994, p. 83-84. See Burn, 1999 on the distinction between Eurocurrency and Eurobond markets.
[24] Moran, 1991, p. 63 - 64.
[25] Triffin, 1960.
[26] Block, 1977, chapter 6.
[27] For an elaborated account, see Aronson, 1977, chapter 4. De Cecco, 1986 also points to the importance of developments in US domestic regulations in the post-war period.
[28] Helleiner, 1994, p. 85.
[29] Aronson, 1977, p. 173.
[30] Aronson, 1977, p. 83/84.
[31] Aronson, 1977, p. 70.
[32] Kindleberger, 1993, p. 441.

both regulations had limited success in stemming dollar outflows, they also ended up giving US banks an incentive to open subsidiaries abroad.[33]

While private sector lobbying had led to the existence of the loopholes in the first place,[34] US public actor interests coalesced with these private interests. For the US government, the Euromarket offered an opportunity to avoid domestic adjustment and allow balance of payments deficits to be financed by foreign governments and private investors.[35] In other words, the preferences of American authorities changed as a result of the continuing balance of payments problems that resulted from politically more important activities like the Vietnam War. Consequently, the seemingly restrictive US governance pattern ultimately led to a change in market structure reflected in the growth of the Euromarkets.

Table 3.1 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

* 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 the discussion above made clear, the Euromarkets were crucially enhanced by the governance pattern with respect to foreign currency deposits in both Britain and the US. However, their explosive growth was also driven by the private opportunities for profits the Euromarkets provided. Well-placed firms capable of implementing a strategy of internationalisation could gain a competitive advantage from being active in the Euromarkets. Once again, the American governance pattern played an important role in explaining the attractiveness of Euromarkets for banks with an eye on the bottom line. First of all, American banks were constrained by regulation Q. Under regulation Q, the Federal Reserve could set limits on deposit interest rates. At times when regulation Q started to bite (keeping deposit rates well below money market yields), depositors had an incentive to move deposits abroad into the Euromarkets.

A second profit opportunity the Euromarkets provided had to do with the reserve requirements imposed on banks and had much wider application. To control the money supply, central banks in many countries set compulsory reserve requirements at the central bank

[33] As mentioned, this gave an impetus to the growth of the Euromarkets, but also led to the establishment of Caribbean shell companies. Aronson, 1997, p. 78.
[34] Helleiner, 1994, p. 88/89.
[35] Helleiner, 1994, p. 90/91.

on which no or low interest was paid. As foreign currency deposits are usually exempt from reserve requirements, they have a cost advantage. This advantage consisted of the average interest rate on assets (representing the opportunity costs) multiplied by the reserve requirement percentage (e.g. with a 4 per cent reserve requirement and an 8 per cent average interest rate on assets domestic deposits incurred a 0.32 per cent cost versus zero costs for Euromarket deposits).[36] These divergent profit opportunities resulted in a spectacular growth of the Euromarkets. Table 3.1 above showed two measures for the absolute volume of the Euromarkets. The numbers translate into an annual growth of the net size of the Eurocurrency market over the period 1964 – 1980 of 30 per cent.[37]

Banks from all over the world came to London to have their piece of this fast-growing pie. The competitive success of the UK deregulatory move led to similar initiatives by a number of other financial centres, creating a wave of competitive deregulation. This led to 'offshore' financial markets mimicking London all over the industrialised countries[38] and encouraged the internationalisation of the banking sector (see further below on competitive deregulation in the 1980s). Table 3.2 lists the presence of foreign branches or majority-controlled subsidiaries in selected OECD countries. This not only shows that more banks had access to 'offshore' facilities domestically, but that their access to foreign markets increased as well. Moreover, while the UK (London) definitely started out as the most internationally connected financial centre, other financial centres caught on.

[36] On regulation Q and the cost advantage as factors in the growth of Euromarkets, see Dale, 1984, p. 12-13.
[37] It should be noted that long-run historical, comparative or global level data on the financial system suffers from a significant amount of measurement and definition problems. This means that many data sources do not match perfectly. The different statistics from various sources shown here do, however, generally point in the same direction, with only differences in magnitude and speed of trends.
[38] Dale, 1984 provides an overview of how 'Euromarkets' were created in many different financial centres, p. 33 – 48.

Table 3.2 Internationalisation of banking, 1960 – 1981 (foreign banking presence, number at year-end)[39]

	1960	1970	1973	1979	1981
Belgium	14*	26	38	51	56
France	33	58	76	116	131
Germany	24	77	n/a	149	148
Italy	2	8	15	36	38
Japan**	34	38	58	85	94
Netherlands	n/a	23	27	39	40
Switzerland	n/a	97	99	96	107
UK	51***	95	129	214	229
US	n/a	n/a	124	345	459

* data for 1958 ** foreign branches only *** data for 1962 Source: Pecchioli, 1983, table III.1, p. 69.

Faced with this re-emergence of global finance and the accompanying capital flows, Western countries recognised early on that the resources available to the IMF at the time might not be sufficient to offset the capital flows in case of balance of payments disorders.[40] In other words, a change in market structure led to an adjustment of the preferences of the public sector with respect to their mutual insurance under the IMF. The IMF's role as financier of temporary balance of payments deficits was therefore augmented in 1962 with the General Arrangements to Borrow (GAB).[41] In this agreement ten industrial states agreed to provide additional sources to the Fund if necessary. Initially this additional funding was restricted to lending to the participants in the GAB. These ten states were Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. In 1964, Switzerland joined the GAB. In the wake of the Latin American debt crisis a thorough review of the GAB took place, and it was not only significantly expanded, but the restriction to lend to GAB members only was lifted. While this paved the way for supporting IMF loans to emerging markets, such a situation only occurred during the Russian financial crisis of 1998.[42]

The GAB is not only relevant as a monetary mechanism to 'leverage' the IMF and enhance its role in sovereign debt crises. It also led to the establishment of the G10, a policymaking institution where the finance ministers and central bank presidents of the GAB member states meet on a regular basis (the later participation of Switzerland did not lead to a name change to G11). The GAB and G10 increased the power of these states over the IMF even further (as they could veto any use of the GAB) and reduced the multilateral nature of the Bretton Woods system. More importantly, the G10 proceeded to discuss a wide range of monetary issues and produced several high-profile policy reports. For example, in 1965 their report on proposals regarding the creation of reserve assets laid the basis for the Special Drawing Rights of the IMF.[43] The relevance of the GAB and G10 consequently lies in its role as an authoritative policymaking institution of the global creditor states, as we will also see in chapter five on the resolution of sovereign debt crises.

Despite the 'reinforcement' of the IMF with the GAB, the inherent tension of the Bretton Woods system (the Triffin dilemma) became increasingly visible when an initial cautious choice for supplying international liquidity by US authorities was overtaken by the rapid growth of Eurodollar markets. This put the system under increasing strain. The pool of footloose funds supplied by the Euromarkets (in 1970 already substantially larger than global international reserves) and the increased velocity of movements in the foreign exchange markets made it much more difficult for national authorities to maintain fixed and stable exchange rates.[44]

The Euromarkets had created an 'offshore' space in the international financial system where the national level public governance pattern of the Bretton Woods system was rolled back in favour of global markets. As the discussion above showed, this was to an important extent the result of political (non-)decisions, especially by the British and American financial authorities. In other words, the policymaking processes at the domestic level led to a shift to less stringent governance patterns in accordance with the preferences of financial market actors and financial authorities alike. This led to the emergence of a new international market, transforming the predominantly nationally oriented financial market structures beyond recognition.

These shifts in governance and changes in market structures naturally also fed back into the preferences of public and private actors. The preferences of market participants for fixed exchange rates slowly adjusted to the reality of the Euromarkets over the course of the 1960s. Where MNCs first appreciated the stability of fixed exchange rates, the increasing strains in the Bretton Woods system (and the accompanying imperfect restrictions) led them to believe that free floats were preferable above politically induced and restrictive fixed rate practices.[45] Although bankers at the time realised the vulnerability that could arise from floating rates, they apparently also expected to be able to profit from flexible exchange rates.[46]

39 To illustrate the point made in footnote 37: Tschoegl, 2000, table 1, p. 7 provides different numbers for foreign banking presence when looking specifically at the main financial centres. The trend is clearly the same, however:

	1970	1975	1980	1985
London	181	335	402	482
New York	75	127	253	326
Tokyo	64	115	139	170

40 Helleiner, 1994, p. 96 provides this explanation for the emergence of the G10.
41 See IMF, 2001 or Block, 1977, p. 178-179 for discussions of the GAB.
42 IMF, 2001, p. 73 – 74.
43 G10, May 1965. It should, however, be noted that the track record of the G10 is mixed (especially after the emergence of the G7). From my own experience in the Dutch Ministry of Finance I know that the non-G7 members of the G10 (Belgium, the Netherlands, Sweden and Switzerland) always struggled to keep important policy discussions in the G10 and to convince G7 members to take up new issues.
44 Strange, 1976, p. 176 – 177.
45 Aronson, 1977, p. 142.
46 Aronson, 1977, p. 106.

On the official side, the Triffin dilemma and its exacerbation by the Euromarkets was well acknowledged, and the recurrent exchange rate pressures on US authorities made them less favourably inclined towards maintaining the Bretton Woods system (as its security preferences – the Vietnam War – trumped economic concerns). Public authorities at the national level increasingly thought they could increase their autonomy by utilising floating exchange rates.

These evolving preferences fed into policymaking institutions at the domestic level (most importantly in the US).[47] Since the US was the key actor in the Bretton Woods system, its decisions to cope with the market pressures (or not) could determine the fate of the whole system. As it turned out, the growth of the Euromarkets and the accompanying speculative capital flows overwhelmed public authorities. To relieve the pressure, the US government decided unilaterally in 1968 to suspend its support for the gold-dollar link in the private market.[48] In August 1971 the United States – again unilaterally – suspended the link between the dollar and gold completely as part of the Nixon administration's 'new economic policy'. The US had freed itself from the bonds of the restrictive Bretton Woods global financial governance pattern, in effect blowing up the whole system. A new episode in the history of the global financial system had started, which will be discussed in the next section.

Governance institutions in search of a mission: 1971 – 1982

The G10 initially attempted to resuscitate the Bretton Woods system. In December 1971 they concluded the so-called Smithsonian Agreement. Under this agreement, the G10 members accepted new parities (although with wider bands) and a devaluation of the dollar. The capital controls of Bretton Woods were largely left intact. However, the Agreement did not manage to stand up to the newly awoken market actors that speculated against the parities. The Agreement broke down in 1973, and the US announced it would abolish its capital controls.[49] A new era in global finance dawned.

The demise of Bretton Woods amounted to a significant shift in governance, especially along the stringency dimension. Both private and state actors were 'unleashed' to pursue their own monetary (exchange rate) and financial policies. As could be expected, the dramatic shift in governance that the abolition of the Bretton Woods system entailed had a significant impact on the market structure in the global financial system. This section will first of all discuss this impact on the market structure. The end of Bretton Woods paved the way for further liberalisation of the international financial system, leading to continued rapid growth.

[47] As mentioned above, the system had turned out less international than the originators had hoped. As a result the dominant policymaking institutions were also situated at the national level.

[48] Block, 1977, p. 194.

[49] Aronson, 1977, p. 102 – 110 and Helleiner, 1994, p. 111.

The second part of this section discusses the newly emerging policymaking processes, as well as the resultant shifts in governance in response to the changing market structures (e.g. the Basel Concordat). As we will see, the US authorities – after their unilateral abolition of the Bretton Woods system – moved to remake the dominant policymaking institutions to their perceived benefit. To this end, existing international monetary and financial policymaking institutions (especially the IMF) were, for the most part, deprived of any meaningful role.[50] Instead, decision-making was focused on the newly established G7. Other new policymaking institutions emerged, such as the G30 and the BCBS, and several existing policymaking institutions (re)gained prominence due to the market structure developments (e.g. the BIS and the Paris Club).

The growth of the international financial system in the post-Bretton Woods era can be witnessed on a number of levels. As table 3.1 above already showed, the Eurocurrency market increased tenfold from 1970 to 1980. The presence of foreign banks in the major industrialised countries increased significantly between 1970 and 1981, as was shown by table 3.2. The table reflects that rising economic powers like Germany and Japan also gained prominence as financial centres: foreign banking presence in Germany rose by 53 banks from 1960 to 1970 and by another 72 from 1970 to 1979. For Japan these numbers are only 4 in the 1960s while 47 banks established a presence between 1970 and 1979. This growing international presence of banks is also reflected in the relative importance of international business on the balance sheet. Table 3.3 below shows the foreign business as part of the assets and liabilities of deposit banks. For the whole of the OECD, between 1970 and 1981 foreign assets rose from 12.1 to 23.7 per cent and foreign liabilities from 11.3 to 23.4 per cent of respectively total assets and total liabilities.

[50] Aronson, 1977, p. 139.

Table 3.3. Relative importance of foreign business for banks (% of total)

country	assets		liabilities	
	1970	1981	1970	1981
Belgium	33.4	57.8	39.0	68.7
Canada	19.8	17.3	14.3	27.1
France	15.9	33.7	17.0	32.3
Germany	8.8	10.2	5.6	8.1
Italy	12.6	12.6	12.6	15.9
Japan	3.7	6.6	3.1	7.9
Netherlands	27.0	39.8	25.9	39.2
Sweden	7.0	9.7	5.4	18.2
Switzerland	33.7	50.1	28.9	42.8
UK	46.1	67.9	50.2	69.9
US	2.6	15.1	6.2	11.3

Source: Pecchioli, 1983, table I.3 (p. 19).

The banking sector not only internationalised, but also diversified its business as part of a wider trend of cross-sector integration in the financial system (see also below). Loss-making experiences with the volatile currency trade led to a reorientation of their business model towards sovereign borrowing, for example.[51] This development was fuelled by the oil crisis of the early 1970s and created global balance of payments imbalances: large current account deficits in many emerging markets and a huge build-up of reserves in oil-exporting states.[52] This subsequently led to a strong supply-side push for credits, which banks were more than happy to accommodate by 'recycling' petrodollars into emerging market debts. This is also reflected in Wionczek (1979) who points to a "frantic search for new, less indebted clients" in the late 1970s on the part of banks as more and more 'good credits' became indebted to the point that doubts arose about their debt sustainability.[53] It is estimated that by 1981, one third of net international bank claims were comprised of medium-term roll-over syndicated international loans.[54] Table 3.4 shows the impact this development had on banks' balance sheets.

[51] Aronson, 1977, p. 164. See also Llewellyn, 1985, p. 212.
[52] See for example Llewellyn, 1985.
[53] Wionczek, 1979, p.186.

Table 3.4 Bank claims on developing countries (billion US$ and % of total claims)

	1970		1975		1981	
	billion $	%	billion $	%	billion $	%
Eastern Europe	2.2	2.4	21.6	4.9	60.8	3.9
OPEC countries	1.0	1.1	14.3	3.2	72.2	4.7
Other developing countries	9.7	10.5	63.0	14.3	230.0	14.8

Source: Pecchioli, 1983, table I.8 (p. 25).

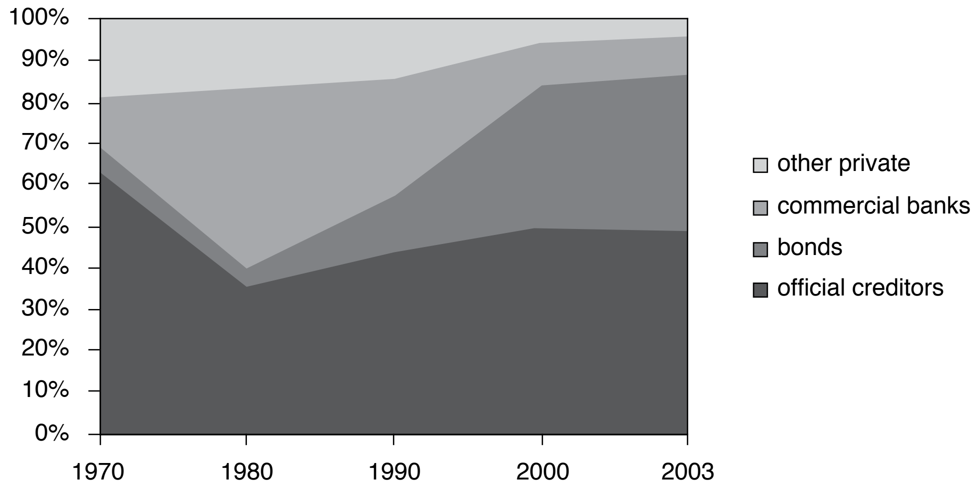
The fall of Bretton Woods had evidently led to a significant change in the market structure in the banking market through the internationalisation it allowed. For internationalised banks competition now took place in an international arena, instead of at the domestic level. The market structure on the demand side of the market for sovereign credit had changed as well. With Bretton Woods controlling private capital flows, sovereign credit was mostly a 'public' affair. Loans were provided by other states or International Financial Institutions (IFIs). The fall of Bretton Woods, however, allowed states (including emerging markets) to gain access to international private sources of finance. Confronted with a deterioration of current account and fiscal balances as a result of the oil crisis, many emerging markets postponed domestic adjustment due to the new economic reality of higher oil prices by lending on the international financial markets. These states had a preference for 'non-conditional' bank loans over IMF credit or domestic adjustment. Contrary to neoclassical theory and expectations, 'market discipline' for states in need of adjustment did not occur due to the supply-side push of credit. In a way, this debt build-up in non-oil exporting emerging markets can consequently be seen as the precursor of the trade-off between domestic adjustment, official refinancing and private sector restructuring in sovereign debt crises.[55]

These developments in the market for sovereign credit led to a structural shift from bond financing (common pre-1970s) to bank financing, and – more importantly – from official to private financing.[56] As figure 3.1 on the next page shows, the proportion of commercial bank borrowing in emerging market debt stocks grew rapidly. These loans were put together by syndicates of banks, often involving dozens of banks worldwide. Over the period 1970 – 1982, 42 per cent of Latin American Euroloans had American lead managers, with 9.7 per cent Japanese lead managers and 48.4 per cent having lead managers from other (mainly European) countries.[57] This syndication was one of the key innovations in the financial markets of the 1970s.[58] American and European authorities generally refrained from regulating bank activities

[54] Pecchioli, 1983, p. 34.
[55] Cohen, 1982.
[56] Llewellyn, 1985, p. 208.
[57] Stallings, 1990, p. 5 (table 1).
[58] Oliveri, 1992, p. 35 – 40 discusses syndicated lending in the context of his analysis of the Latin American debt crisis.

in these markets, as also echoed by the chairman of the BCBS: "Country risk, as one form of credit risk, is a matter of commercial judgement and decision of each bank on a case-by-case basis. But, as with all kinds of risk exposure in banks' business, the essential characteristic is that it should not be excessive in relation to a bank's capacity to meet losses."[59]

Figure 3.1. Composition of long-term debt stocks of middle-income countries



Source: World Bank, 2005.

This rapid cross-border expansion of the financial system and the new currency volatility in the aftermath of Bretton Woods certainly did not lead to a stable market-based order. For one thing, banks had to get used to managing the risks of currency volatility. In the post-Bretton Woods system of free floating exchange rates cross-border bank loans could suddenly decrease in value due to adverse exchange rate movements. Furthermore, speculative currency trading on their own books could lead to losses for banks. Parallel to the internationalisation of the banking market, capital ratios of banks had, however, started to decline (see table 3.5 for data on the US).[60] This was especially pronounced for internationally active banks (such as the 17 largest mentioned in the table). Thus while risks increased (e.g. due to currency volatility), bank capital – which is one of the prime ways to ensure the safety and soundness of banks - was decreasing.

[59] Cited by Peccioli, 1983, p. 89.
[60] Saunders & Wilson, 1999 examine capital ratios as book asset values vis-à-vis book value of equity for Canada, the UK and the US. They too find a downward trend for Canada and the US over the 1960s and 1970s, while the UK seems to show a slight increase (with a significant dip in 1974/1975).

Table 3.5. US bank capital ratios, 1970 – 1981 (% of equity to total assets)

Year	1970	1975	1980
All banks	6.58	5.87	5.80
17 largest banks	5.15	3.94	3.69

Source: Tarullo, 2008, table 2.1 (p. 32).

Not surprisingly, these developments led to a number of high-profile bank failures, which in this new market context had significant international ramifications. Moreover, supervisors had little idea how to ensure burden sharing during financial rescue operations. A prominent example was the 1974 Herstatt Bank crisis. This bank was brought down by currency speculation gone wrong (and which it had tried to cover up fraudulently). More importantly, when the day of reckoning came, the German supervisors decided to shut the bank down at the close of the German business day. In practice, that meant that Herstatt Bank had received its D-mark payments on current transactions, but had not yet paid its US-based counterparts in the currency transactions.[61] This brought counterparty banks all over the world in trouble as it cascaded through the system (a freezing of the interbank market very similar to the 2008 credit crunch).

The developments in the market structure described above led to adjustments in the preferences of different actors (both public and private), which will be discussed below. All actors (public and private) realised the new risks had to be managed. But first and foremost, they led to preference adjustments with respect to the major policymaking institutions. A number of new policymaking institutions emerged, and the roles of existing policymaking institutions changed. At the most general level, the internationalisation of the financial system played an important part in the emergence of the G7 and the G30. The developments in the market for sovereign credit were reflected in the work of the (existing) Paris Club. And last but not least, the developments in the banking sector also led to a new role for the BIS and the emergence of the BCBS under the heading of the BIS. These policymaking institutions will be discussed in more detail below.

The increasing economic interdependence, which of course was especially prevalent in the financial and monetary domain (as has become clear above), is the most commonly cited explanatory factor for the emergence of the G7. This interdependence increased the interests of public policymakers in policy coordination. However, as the G10 had already served to strengthen the relations between financial policymakers in the 1960s, it begs the question why a – strengthened – G10 process did not emerge as the dominant policymaking forum for monetary and financial matters. Baker (2006) argues that the answer to this question lies

[61] Helleiner, 1994, p. 173.

in the US preference for a less Eurocentric forum.[62] This shows the realities of policymaking processes in the context of power relations, and how policymaking institutions can become the 'structural' exponent of these power relations. The US preference gradually evolved into the G7.

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. In September 1973, at the IMF Annual Meetings in Tokyo, the Japanese Finance Minister invited these four countries to a similar informal meeting, and managed to 'institutionalise' this G5 by agreeing to continue to meet. The next step in the emergence of the G7 was the insistence of the president of the Federal Reserve, Arthur Burns, to be invited, which was subsequently followed by the central bank presidents from the other countries. The G5 meeting of finance ministers and central bank presidents was born. When some of the original finance ministers became heads of state, they recreated the informal setting on a heads of state level, and in the process the Italians and Canadians were invited to join as well by respectively France and the US. As such, the G7 as we now know it had taken shape (although the financial arm of it continued to meet as the G5 for a while longer). In 1982, the G7 heads of state decided that the G5 should meet periodically, and that this meeting should include the Managing Director of the IMF. Only in 1986, and after heavy pressure, were Italy and Canada invited to join the finance ministers meeting.[63]

During the first decade of its existence the G7 seemed to be mostly preoccupied with the consequences of the collapse of Bretton Woods and the international macroeconomic and monetary coordination of its aftermath. The changes in market structure described above also led to adjustments in the preferences of relevant actors, specifically with respect to the governance of exchange rates. MNCs became more vocal in calling for a managed float as they suffered exchange rate losses.[64] After the Herstatt Bank collapse, bankers also became less enthusiastic about floating exchange rates. Central bankers, on the other hand, sought to regain a position in the new world of floating exchange rates. These different preferences translated into one of the first major achievements of the emerging G7: the Rambouillet Agreement of 1975. The countries of the G7 inter alia accepted floating exchange rates, yet pointed out that "our monetary authorities will act to counter disorderly market conditions, or erratic fluctuations, in exchange rates."[65] In other words, the G7 advocated a governance pattern of managed exchange rates or 'dirty floats'.

[62] The following short history of the G7 is based on Baker, 2006, especially chapter 2. The observation that the US sought new policymaking institutions in which it could strengthen its dominance is corroborated by Aronson, 1977, p. 139.
[63] Baker, 2006, p. 26, mentions that Secretary of the Treasury Baker even apologised to his G5 colleagues for the extension of membership, which was granted by President Reagan.
[64] Aronson, 1977, p. 151.
[65] G7, 17 November 1975.

The Rambouillet Agreement showed the success of the US strategy of relocating the primary decisions in the monetary and financial area to a more 'friendly' policymaking institution, underpinning with political authority new structures in the foreign exchange and debt markets. Over time the G7 has emerged as the 'apex forum' in global financial governance, i.e. the policymaking institution that coordinates and steers actions by other international bodies and states.[66] The G7 functions as a highly informal and personal club, with no permanent secretariat, no minute-taking and little bureaucratic support. There are no formal decision-making procedures or 'votes'.

A second new policymaking institution that responded to the increasing internationalisation and integration of the financial system was the G30.[67] The G30 was established in 1978 with support from the Rockefeller Foundation and is composed of high-level representatives of public and private actors, as well as academics. Its membership criteria seem to be "brains, a background of public service, economic literacy, (..) influence – either practical or intellectual – and commitment to the Group's purposes."[68] It presents itself as "a private, non-profit international body (…) [that aims] to deepen understanding of international economic and financial issues."[69] From its inception, this link between financial and international economic concerns (and therefore also monetary issues) was one of its main innovations.

The G30 holds closed-door meetings where views on global developments are exchanged, and it incidentally produces policy reports (which are often influential). As one of the architects of the G30 puts it: there is often disagreement on analyses and policies but through the meetings and by working together "there is at least a reduction of opposition to a level of silence."[70] Although in its early days it addressed a wide range of topics, in the late 1980s it turned to finance and became more specialised and technocratic.[71] Its reports continue to carry significant weight, as will become clear in the case study on bank capital adequacy standards. The significance of the G30 is that it is a relatively clear and open example of the close interlinkages between public and private policymakers at the global level, as well as of the process in which consensus is forged (a problem definition and yardstick to measure solutions against are defined).

Coming to the market for sovereign credit, the shift from official to private financing had a significant impact on the main policymaking institution of the time, the Paris Club. In the Paris Club, main creditor countries come together to negotiate debt workouts with over-indebted countries. It originates from a 1955 agreement by six European countries to pursue

[66] See Baker, 2010 for an elaboration of the concept of apex forums.
[67] See MacRae, 1990 for a short history on which this paragraph is based. This is a history to which the G30 itself refers on its website (www.group30.org) and which is unsurprisingly rather positive about the G30's achievements. See also Tsingou, 2007 for a more nuanced view.
[68] MacRae, 1990, p. 88.
[69] www.group30.org.
[70] Edwin Deagle quoted in MacRae, 1990, p. 77.
[71] Tsingou, 2007.

a coordinated approach to debt renegotiations with Brazil.[72] The first official Paris Club debt workout took place in 1956 with Argentina. The US appears to have joined only in 1964,[73] while a formal secretariat under the aegis of the French Treasury was not established until 1974. Decisions in the Paris Club are made by consensus, or in other words, a one-country-one-vote system where unanimous decision-making applies. Any creditor with substantial exposure to a debtor country can be invited to join specific negotiations, but 19 permanent members have emerged in the early 1990s.[74]

When official bilateral debt was still the lion's share of debt crises, private debts were dealt with through the so-called 'comparability of treatment clause'. This clause implies that a debtor country must treat all its creditors in a comparable way to the official creditors of the Club, or more specifically: that the debtor cannot grant better terms to other creditors. The application of this clause gives the Paris Club potentially a huge leverage over debtor countries' dealings with private creditors: if a Paris Club agreement led to a haircut, the same reduction in NPV should be applied to private creditors.[75]

In the early days of the Paris Club, the informality of its arrangements was underscored by the fact that there were no agreed principles or standardised models for the debt workouts.[76] Each case was decided on its own merits, making it a particularly light form of governance. From 1966 onwards, the Paris Club demanded that countries have an IMF programme in place before they could receive Paris Club treatment; in other words, the onus was on debtor countries to undertake domestic adjustments.

The Paris Club's work really took off after 1978. In the period 1978 – 1984 it handled 56 workouts, more than double the total amount of workouts since its inception. The numbers continued to grow in the 1980s, while in the 1990s they totalled 63 throughout the decade.[77] The set of debtor countries receiving Paris Club treatment changed in composition over this period. This reflected the changing composition of debt stocks of emerging markets shown above. More and more, the Paris Club dealt mainly with low-income countries, which did not have access to private sources of finance. This also meant that the attention shifted from rescheduling debt towards outright debt forgiveness (which was considered from 1988 onwards). This development in the countries receiving 'Paris Club treatment' implies that it became less relevant as a policymaking institution in the sovereign debt crisis resolution case

[72] The founding members were Austria, Belgium, Germany, Italy, the Netherlands and the UK, later joined by Denmark, France, Luxembourg, Norway, Sweden and Switzerland. Rieffel, 2003, p. 58.
[73] Rieffel, 2003, p. 58 (footnote 4).
[74] Rieffel, 2003, p. 64-65. The nineteen members are Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, the Russian Federation, Spain, Sweden, Switzerland, the UK and the US. Note that most, though not all, of these members also have a seat in the IMF's Executive Board. The meetings are observed by the European Commission, IMF, MDBs, OECD and UNCTAD.
[75] See De Jong and Van de Veer, 2010 on this point.
[76] Rieffel, 2003, p. 68.
[77] Brown & Bulman, 2006, p. 12-13.

study as defined in this thesis (which is focused on emerging markets). It also meant the potential of the comparability of treatment clause as an official policy towards sovereign debt restructurings has not been thought through, nor has it had practical repercussions. Only in 2003 under its new 'Evian approach' is debt reduction also being considered for middle-income countries, potentially increasing its relevance in future discussions on the governance of sovereign debt crises.[78]

As mentioned, a significant shift in the market for sovereign credit towards private financing had occurred during the 1970s. In response to this, a private sector counterpart to the Paris Club emerged, the London Club. This Club was forged in the process of dealing with a number of sovereign debt crises in the second half of the 1970s.[79] More formally, 'London Club' refers to a process of setting up Bank Advisory Committees, and the principles commonly used by these Committees. Private banks were encouraged by the IMF and G7 finance officials to coordinate their actions in sovereign debt crises. This led to a culture of coordination between private banks, and the London Club has dealt with over 200 sovereign debt crises since 1980. The London Club is highly flexible and employs a tailor-made approach to each sovereign debt crisis. It has no fixed membership, secretariat and – as it seems – procedures. It operates under three main principles: a case-by-case approach, voluntarism and market-based restructurings. The relevance of the London Club seems to have been largely surpassed by the IIF, specifically after the agreement on the Principles for Stable Capital Flows (see below and the discussion of the Principles in chapter five).

Coming to the response to the changing structure of the banking market, the rise in prominence of the BIS as a major international policymaking institution is noteworthy. The BIS was set up in 1930 with the original mandate to "promote the co-operation of central banks and to provide additional facilities for international financial operations; and to act as a trustee or agent in regard to international financial settlements entrusted to it under agreements with the parties concerned."[80] The BIS was seen as "proposed, designed, and backed by financiers and central bankers."[81] One of the main functions during its early years was dealing with Germany's sovereign debt problems (following from the reparation payments after the First World War), and the BIS intended to do so by commercialising Germany's debt (hence providing a spur for global financial markets and preventing their likely breakdown in case of a German default).[82]

The BIS has a somewhat curious membership and decision-making structure. It is set up as a limited liability company under Swiss law, and its founding shareholders are the central banks of Belgium, France, Germany, Italy and the UK. Since the US government decided not

[78] De Jong & Van der Veer, 2010, p. 144.
[79] Rieffel, 2003, chapter 6 is one of the few studies of this under-researched Club on which this paragraph is based. See also Hudes, 1985.
[80] BIS statutes of 1930, cited by Seabrooke, 2006, p. 141.
[81] Simmons, 1993, p. 362.
[82] Simmons, 1993, p. 398 - 401.

to join it at its inception, its shares were initially sold to private banks (the same applies to those of Japan). It has evolved to become the 'bank of central banks', with currently 55 central banks representing all main economies holding shares. Its Board of Directors consists of six ex officio members (the central bank presidents of Belgium, France, Germany, Italy, the UK and the US), who all appoint a second board member. The Board can elect up to nine additional members, and currently has eight elected members (representing Canada, China, Japan, Mexico, the Netherlands, Sweden, Switzerland and the ECB).[83] The 'deputy' board members were originally appointed from the private sector.[84] Until recently, the Board only consisted of G10 members, but after the 2007 crisis and the rise in prominence of the G20, Mexico and China have been added to the Board of Directors.

Curiously, during the negotiations on Bretton Woods, a resolution was tabled to abolish the BIS at the earliest convenience.[85] This would have entailed the dismantling of the premier pre-War global policymaking institution regarding financial matters and sovereign debt resolution, in favour of the IMF. The resolution was never executed, and in the 1950s and 1960s the BIS arranged currency swap arrangements in support of the Bretton Woods system.[86] It also retained importance as a central bank hub. In the 1970s the BIS rose to prominence as a regulatory forum as well, mainly through the BCBS (see below). Currently, the BIS has a staff of about 550 people and also hosts a number of other forums (the Financial Stability Board, the International Association of Insurance Supervisors and the International Association of Deposit Insurers).

The 1974 Herstatt Bank and other contemporary bank failures pointed to the need for more information sharing and greater cooperation among bank supervisors (instead of the ad hoc approach followed at the time). Banking supervision could no longer be done solely at the domestic level, especially as an increasingly large part of domestic financial systems consisted of foreign banks. Table 3.6 below provides foreign bank assets as a percentage of total bank assets, and reflects the importance of international agreement on adequate supervision of this foreign bank presence. At the instigation of the governor of the Bank of England, the G10 central bank governors therefore established a Standing Committee on Banking Regulations and Supervisory Practices based in the BIS (now known as the Basel Committee on Banking Supervision, BCBS) in 1974.[87]

[83] Factual information from www.bis.org (accessed March 2011).
[84] Seabrooke, 2006, p. 142.
[85] Aronson, 1977.
[86] Seabrooke, 2006, p. 143.
[87] Kapstein, 1994, p. 44.

Table 3.6. Foreign banks' assets (% of total domestic banking assets)

host country	1960	1970	1973	1979	1981
Belgium	8.2*	22.5	28.6	35.5	46.8
France	7.2	12.3	14.1	14.3	17.4
Germany	0.5	1.4	n/a	3.2	3.6
Italy	n/a	n/a	n/a	1.5	2.3
Japan	n/a	n/a	1.6	2.6	2.5
Netherlands	n/a	n/a	n/a	13.0	18.0
Switzerland	n/a	11.0	11.4	10.8	11.6
UK	n/a	n/a	n/a	59.0	60.2
US	n/a	n/a	3.4	9.7	13.4

* data for 1958 Source: Pecchioli, 1983, table III.2 (p. 69).

The objective of the BCBS is currently "to improve supervisory understanding and the quality of banking supervision worldwide," but in its initial phases the BCBS concentrated its efforts on "clos[ing] gaps in the supervisory net."[88] The emergence of the BCBS marks a very important development in the policymaking process dealing with the governance of banks. It is worth noting that the policymaking process became focused on a policymaking institution based in the BIS, historically seen as closely aligned with the private sector. It furthermore meant that discussions on global banking supervision were dealt with by G10 central bankers and bank supervisors, excluding non-G10 and 'non-financial' voices.[89] The BCBS is semi-autonomous within the BIS, in the sense that G10 governors rarely overturn proposals by the Committee.[90] Its success as a policymaking institution can furthermore be attributed that there is a high-level sense of common purpose within the BCBS. With the internationalisation of banking, central bankers and supervisors realised that supervision was only as good as its weakest link (the supervision in the state with the weakest supervision).[91]

The internationalisation of the banking market had led to adjustments in the preferences of both private and public actors with respect to governance patterns, and these preferences met in the new policymaking institution of the BCBS. For banks, the increasing importance of cross-border business translated to the bottom line. Although no solid data is available, there seems to have been wide agreement that international business accounted for a sizable proportion of overall bank profits.[92] However, banks became increasingly aware of regulatory differences between countries and the administrative burdens these entailed. Internationalised

[88] BIS, July 2006, p. 1.
[89] In light of the current financial crisis, membership of the BCBS has been widened to represent the G20.
[90] Off-the-record interview with public official, 1998.
[91] Off-the-record interview with public official, 1998.
[92] Pecchioli, 1983, p. 45 cites a 1982 G30 study.

banks consequently gained an interest in the coordination or even harmonisation of the governance of the banking sector, to reduce this burden (as well as risks resulting from international business). Furthermore, the internationalisation increased the importance for banks of a 'level playing field' in international competition (or better: of the prohibition of policies leading to advantages for foreign competition). Again, this led to an interest of private financial actors in the coordination or harmonisation of regulation (in other words, a shift in governance upward along the jurisdictional dimension with more jurisdictions applying the same rules).

In the same period, banking supervisors on the public side awoke to the new financial risks and instability emerging as a result of the new global financial system they were creating, and realised that more international cooperation was necessary (as also reflected in the establishment of the BCBS). As early as in 1975, the discussions in the BCBS led to an agreement delineating supervisory responsibilities between the home and host countries of internationalised banks: the Basel Concordat. The Concordat was a response to the internationalisation of the banking sector, but also facilitated further internationalisation (as the tables above also underscore). It mainly established that parent and host authorities are jointly responsible for the supervision of internationalised banks, with hosts keeping an eye on local branches while the parent authority also has a responsibility for the solvency of the bank as a whole. This reduced the administrative burden on internationalised banks. It entailed a shift in governance up the jurisdictional dimension, regulating the behaviour of G10 bank supervisors (and hence also of the banks under supervision).

Importantly, the Concordat established a spirit of cooperation between banking authorities, while at the same time institutionalising this cooperation by codifying it in the Concordat.[93] However, the further internationalisation of the banking market also brought banks into non-G10 emerging markets, which did not always have proven adequate supervisory capacities. Therefore, in 1983 the Concordat underwent a major revision by including consolidated supervision.[94] On the one hand this reflected the concern of supervisors for the solvency of their institutions, and is also a restrictive arrangement for the banks, yet on the other hand it also paved the way for banks to continue their expansion into these countries with the blessing of their home country supervisor.

The decreasing capital ratios mentioned above (see also table 3.5 above) had also provoked increasing interest among G10 banking supervisors in light of the safety and soundness of their home country banks. The BCBS conducted some conceptual work on this issue, seeking to achieve "greater convergence among its members with regard to national definitions of bank capital for supervisory purposes."[95] Many supervisors had historically analysed capital

[93] Wood, 2005, p. 54.
[94] Wood, 2005, p. 56.
[95] BCBS, 1981, quoted in Norton, 1995, p. 183.

adequacy ratios, but with a wide variety of definitions and measurements.[96] The G10 governors explicitly did not seek convergence of the capital standards; they just wanted to prevent a further deterioration of the capital levels.[97] This was mainly due to the perceived problems with harmonisation, not in the least due to strong opposition from domestic banking interests.[98]

Harmonisation at the global level would prove difficult as formal supervision of the safety and soundness of banks was usually based on a variety of other approaches rather than capital ratios. For example, the US Federal Deposit Insurance Corporation (FDIC) used a gearing ratio determining the regulatory capital based on total bank balance sheet value. The Japanese supervisors, on the other hand, relied on the so-called convoy system, where healthy banks were persuaded to incorporate banks in trouble if need be, without setting formal standards on individual banks. The UK had moved to a risk-weighted capital adequacy ratio in 1980.[99]

There was some harmonisation at the regional level, however, under the European Community's programme to integrate European markets (the '1992' agenda). These efforts had started in 1973, culminating in the adoption by the European Council in 1977 of the First Banking Coordination Directive.[100] This directive combined agreements on home-host country issues within the European Community with some preliminary steps towards harmonisation of supervisory standards. The Directive required supervisory authorities to "establish ratios between the various assets and/or liabilities of credit institutions with a view to monitoring their solvency and liquidity and the other measures which may serve to ensure that savings are protected." However, the establishment of these ratios was "for the purposes of observation" in addition to the use of any domestic measures.[101] The method of computing four of these ratios, specifically concerning solvency, had been developed by the Banking Advisory Committee of the European Community.[102] There is, however, no mention of a specific target ratio or the ratios being risk-weighted. The Directive represents a very cautious shifting upwards of the governance of the banking sector within the European Community. Significantly, besides the protection of savers, the Directive points to the aim of creating equal conditions of competition between banks in the European Community.

To summarise, the collapse of Bretton Woods simultaneously opened markets and implied a significant shift in governance, especially along the stringency dimension. Reduced stringency led public and private actors to increasingly engage in cross-border financial integration, changing

[96] Kapstein, 1994, p. 106 - 107.
[97] Norton, 1995, p. 183.
[98] Reinicke, 1995, p. 166.
[99] Wood, 2005, p. 75-76.
[100] First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.
[101] Directive 77/780/EEC, article 6.1.
[102] Pecchioli, 1983, p. 107. The Bank Advisory Committee consisted of top-level representatives of member states' central banks, ministries of finance, and bank supervisors (off-the-record interview with public official, 1998).

the global financial market structure in important ways. The continuing global integration of the financial system during the 1970s subsequently led to adjustments in private and public pre-ferences for governance. These new preferences were reflected in the emergence of a number of new policymaking institutions, and also led to shifts in governance through policymaking processes in these new institutions. For example, market preferences for a reduced administrative burden on international activities coalesced with public preferences for sound supervision in the BCBS leading to the Concordat. The tentative new governance patterns and policymaking institutions that emerged in response to global financial integration would soon be faced with an enormous challenge in the form of the Latin American debt crisis, with which our third episode starts in the next section.

Regulatory competition and financialisation: 1982 – 2005

In the early 1980s, a global recession, rising real interest rates and declining terms of trade for debtor economies combined to produce difficulties for debtor countries to repay their debts.[103] In the summer of 1982, Mexico was the first emerging market to declare it could no longer repay its loans. Many other emerging markets followed, starting the Latin American debt crisis. The crisis endangered the solvency of many Western banks, even to the point of threatening a global systemic banking crisis. This gave a crucial impetus to the policymaking process on the governance of the banking sector and sovereign debt restructurings. These developments are the subject of the following two case study chapters. In this section, the focus lies mostly on what happened 'parallel' to the developments in the two case studies, in order to set these in the wider context of the developments in the global financial system over the 1980s and 1990s.

This section will start by introducing one important private sector actor that emerged directly as a consequence of the Latin American debt crisis: the Institute of International Finance (IIF). Next, attention will be fixed on the developments in the system. First, it is shown how the preferences of different actors adjusted to the newly emerging situation of the 1970s and early 1980s, which resulted in a wave of policy initiatives for capital market integration and a reduction of 'financial repression'. This in turn reinforced the financialisation trend that was already evident in the 1970s. Finally, this account describes how in the 1990s 'technocratic' approaches to the global financial system gained strength. The dynamics of the changing market structures were thus accompanied by changes in the policymaking process and patterns of governance.

But let us first turn to the IIF itself. This 'institute' emerged as the prime private sector lobbying group on international financial issues over the course of the 1990s. The IIF was conceived of in May 1982 at a meeting sponsored by the National Planning Association (an American think tank) and formally created in January 1983.[104] It is noteworthy that the Managing

[103] Oliveri, 1992, chapter 1.
[104] Surrey & Nash, 1984.

Director of the IMF (Jacques De Larosière) and several high-ranking officials from American and British financial authorities were present at the original meeting. The IMF kept close taps on the development of the Institute, and at the request of several executive directors the Board was informed in August 1983 of the IIF's organisation, management, membership and terms of reference.[105] The emergence of the IIF was hence directly stimulated by public authorities.

The IIF's membership is limited to banks with (prospective) international exposure, and 38 banks from Belgium, Brazil, Canada, France, Germany, Italy, Japan, Switzerland, the UK and the US became founding members in January 1983. Already in its first year, membership grew to around 200 and membership currently extends to more than 400 financial institutions from over 70 countries (a growing number of members are investment management and insurance companies).[106] Decisions are made through a working group and committee structure that features self-selecting membership. This means involvement of members in policy discussions varies, depending on the pro-activeness of the member banks themselves. In general this does not lead to under-representation of certain categories of members in the policy discussions. The only member category that had been relatively absent in the early 21st century were the Japanese banks, possibly due to language issues and other practical constraints. An off-the-record interview source indicated that prodding by the Japanese Ministry of Finance might have led to a return to the policy discussions within the IIF.[107]

The IIF was initially established to provide up-to-date financial and economic data of borrowing countries in light of the Latin American debt crisis. The IMF, BIS and OECD agreed to help out on this front by allowing the emerging IIF, as a representative of commercial banks, access to their reports. Although the original meetings discussed a possible role for the IIF as a negotiating forum between debtor countries and the private sector, this was explicitly rejected at its establishment. It was only mentioned that "the Institute will provide a convenient forum through which individual country borrowers may choose to provide and discuss their economic plans and projections."[108] The (interim) board of the Institute was also at pains to emphasise that it did not intend to present a united front of bankers to borrowing countries (out of concern for US antitrust law, it seems).[109] It was furthermore mentioned that the IIF could function as "a focal point for dialogue between the international banking community and multilateral institutions, central banks, and supervisory authorities in the developed countries."[110] However, the IIF started to act as public spokesperson of banks on the debt issue only late in the process (1987/1988) and on bank capital adequacy only in 1990 (after the policymaking process on Basel I had already been concluded).[111]

[105] IMF Archives, 4 August 1983.
[106] www.iif.com, accessed March 2011.
[107] Off-the-record interview with private actor.
[108] IIF, 13 June 1983.
[109] IMF Archives, 4 August 1983, p. 3-4.
[110] IMF Archives, 4 August 1983, p. 5.

The two activities of information gathering on emerging market capital flows and lobbying are still its core business today and make it the main global level private lobby concerned with financial governance.[112] The IIF, for example, sends briefings to all governors and alternate governors of the IMF in advance of the Spring and Annual Meetings of the IMF addressing the policy issues on the agenda. The growth of its membership and importance could be seen as a reflection of a wider financialisation trend, which will be the subject of the following paragraphs.

Although it could be argued that financialisation already appeared in the 1970s, the question is why this trend continued even in the face of the Latin American debt crisis. Helleiner (1994) provides two important – and related – explanations that both have to do with the policymaking process: firstly the influence of an ideological shift among policymakers; and secondly the adjustments in the preferences of domestic policy communities. This combination of changes in ideology and preferences led to a wave of competitive deregulation in the 1980s.[113]

With respect to ideology, the 1980s saw the establishment of what became known as 'neoliberalism'. This set of economic policy ideas was loosely based on the emergence of monetarist and neoclassical theories in economics, and was later epitomised by John Williamson as the 'Washington Consensus' underpinning the conditionality of the IMF.[114] Monetarism had already emerged in the 1950s and 1960s and is closely associated with the work of Milton Friedman.[115] The central tenet of monetarist thought is the importance of the money supply for inflation. Normatively, it has a strong anti-inflationary bias (through restrictive monetary policy). More importantly, the return of neoclassical economics overturned the Keynesian consensus on the importance of demand management, and instead emphasised rational expectations. Market actors will be able to assess the future implications of policies as well as the incentives 'political' actors might have to break commitments (e.g. to keep inflation low), and therefore fixed policy frameworks and targets are the preferable policy option (see further below on central bank independence). It was this latter theoretical development that had the most significant impact on financial policymaking.[116] The political agenda resulting from this theoretical and ideological change gained traction by the coming to power of Reagan in the US (1981) and Thatcher in the UK (1979), both of whom were strongly influenced by neoliberal thought.

However, an equally important explanation for the rise of financialisation were the

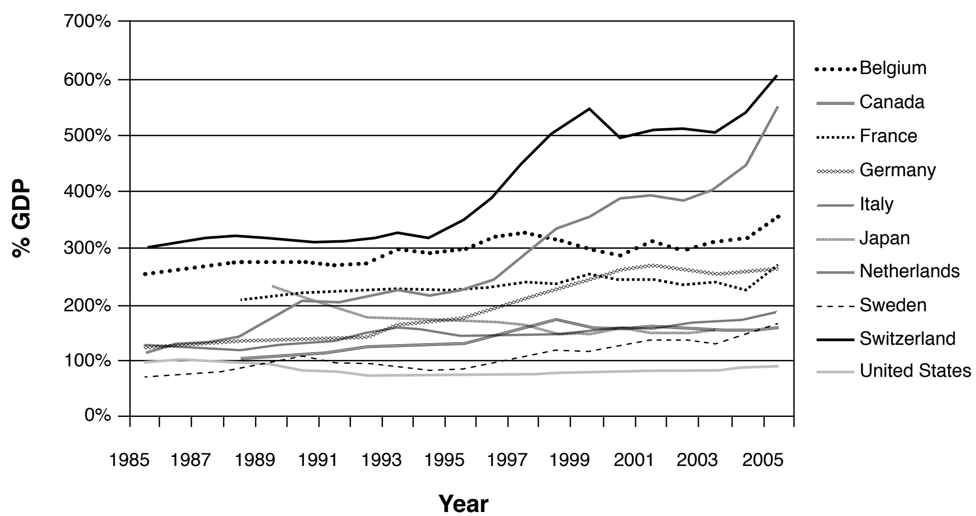
[111] Off-the-record interview source.
[112] Interview with IIF representatives, Washington DC, 25 June 2008.
[113] Helleiner offers a third explanation in the form of hegemonial power dynamics (the UK, US and Japan as respectively fallen, existing and rising hegemonic powers). This explanation seems closely linked to the other two, however. Helleiner, 1994, p. 147 (and chapter 7 in general).
[114] Williamson, 1990.
[115] The seminal references are Friedman, 1956 and Friedman & Schwartz, 1964.
[116] Boughton, 2004 discusses its impact on IMF policy.

adjustments in the preferences of both private and public actors with respect to the governance of financial markets. As already mentioned above, international banking was a lucrative business. Private and public actors realised that getting a position as an international financial centre would benefit the domestic economy (in terms of employment and added value). Moreover, public actors realised that this would also enable them to finance their deficits more easily. The interaction in the policymaking process at the domestic level consequently led to a preference for deregulation of financial markets, so as to remain on par with international competition.[117]

Thatcher had already abolished exchange controls upon taking office, and in 1986 proceeded to abolish many restrictions on the London Stock Exchange (the Big Bang), which turned out to be an important opening salvo in this process.[118] This national level deregulation not only led to further internationalisation, but also to a desegmentation of financial markets over the course of the 1980s and 1990s. Banks increasingly became involved in other financial activities while nonbank financial institutions increasingly encroached on traditional bank activities.[119] The wave of deregulation lasted well into the 1990s. For example, the Glass-Steagall Act, banning US commercial banks from investment banking activities was repealed only in 1999. More importantly the process spread out (much) beyond the major financial capitals.

Research by the IMF shows that financial deregulation (and as a result also cross-

Figure 3.2. Bank balance sheet (assets) as % of GDP



Source: OECD statistics.

[117] See Underhill, 1997 for country examples. See also Moran, 1986.
[118] See Plender, 1987 for an analysis of the Big Bang in the wider context of the liberalisation of the financial system.
[119] IMF, 1998.

border and cross-sector market integration) greatly increased over the course of the 1980s.[120] Using an index measure of financial restriction and openness, the authors demonstrate that although the industrialised countries already set small steps on the path to less restriction and more openness in the 1970s, the real take-off of openness starts in the 1980s. The openness index (measuring estimated gross stocks of foreign assets and liabilities as a share of GDP) increased more than sevenfold in this period, to 1.5. The restriction index declines from more than 0.7 in 1970 to almost zero in 1998 (with a marked acceleration after 1986, as was to be expected). Developing countries show a similar pattern, albeit from a lower base and more moderately. The openness index shows a threefold increase to over 0.3. Developing countries lagged in removing restrictions, however, showing even a small notch up in the restriction index in the early 1980s. Overall the restriction index declines almost 0.3 points, however. It is important to note that especially for the industrial countries these two measures are mirror images. In other words: there is interdependence between developments in the governance pattern of financial markets (fewer restrictions) and the structure of those markets (more openness).

This deregulation dynamic at the national level entailed a shift in governance towards less stringent governance for private actors. Their freedom to do (international) business increased. It will be no surprise that this had a significant impact on the market structure, in the form of financialisation. This broad concept has been used in many different ways, but broadly denotes the continuing expansion of the financial system over the 1980s and 1990s.[121] The expansion of finance takes place on several levels: the volume and number of transactions have risen exponentially, the geographical reach of financial markets has grown and the number of sectors and products that are influenced by financial markets has also increased (e.g. by commodification of corporations[122]).

Two aspects of the financialisation trend are especially relevant for understanding the dynamics of the global financial system: the overall growth of the financial sector and the integration of financial markets (both across borders and market segments). As should be clear from the developments discussed above, the changes on both aspects are both the result of and a further impetus to global policymaking processes regarding financial governance. To illustrate the first aspect of financialisation, the volume of the global financial system (vis-à-vis the real economy), figure 3.2 on the previous page shows total banking sector assets as a percentage of GDP. As is clear in almost all countries, bank assets have risen well above GDP.[123] The relatively modest numbers in the US might be explained by the fact that the data only consists of commercial banks, while many of its largest international institutions were

[120] Prasad et al, 2003, especially figure 2 and p. 14. See also Quinn, 1997.
[121] See for example Epstein, 2005 and Boyer, 2000 for a macro perspective and Langley, 2008; Leyshon & Thrift, 2007; Krippner, 2005; and Froud et al, 2002 for a more micro perspective.
[122] Horn, forthcoming 2011.
[123] In the recent Icelandic crisis, bank assets had grown to well over 800 per cent of GDP. See Buiter & Siebert, 2008.

investment banks. It could also be a reflection of the Anglo-American variety of capitalism where capital markets play a more important role than in continental Europe.[124]

The second aspect of financialisation discussed here is the international integration of financial markets. Of course, the whole preceding discussion of the rise of the Euromarkets is already a reflection of this, showing how banks in the Euromarkets got involved in deposits, currency trading and bonds. The international integration of the banking sector that emerged alongside the Euromarkets continued over the course of the 1980s and 1990s (see also chapter four). International integration was not restricted to the banking sector, however. Table 3.7 below shows cross-border transactions in bonds and securities for the G7 countries (with the exception of the UK, for which no data is available).

The rapid financialisation in the 1980s and 1990s had consequences for the leverage of financial market actors on policymaking. It increased the power of private financial actors: the more influence finance had on economic developments, the more inclined democratically elected politicians were to listen to financial actors in the policymaking process. Both the absolute growth and the integration of financial markets were consequently likely to lead to more leverage for private financial firms in domestic and global policymaking processes. Private actors gained economic clout and geographical reach.

Table 3.7 Cross-border transactions in bonds and equity (gross data, % of GDP)

	1975	1980	1985	1990	1995	1997
Canada	3	9	27	65	189	358
France	n/a	5	21	54	187	313
Germany	5	7	33	57	172	253
Italy	1	1	4	27	253	672
Japan	2	8	62	119	65	96
US	4	9	35	89	135	213

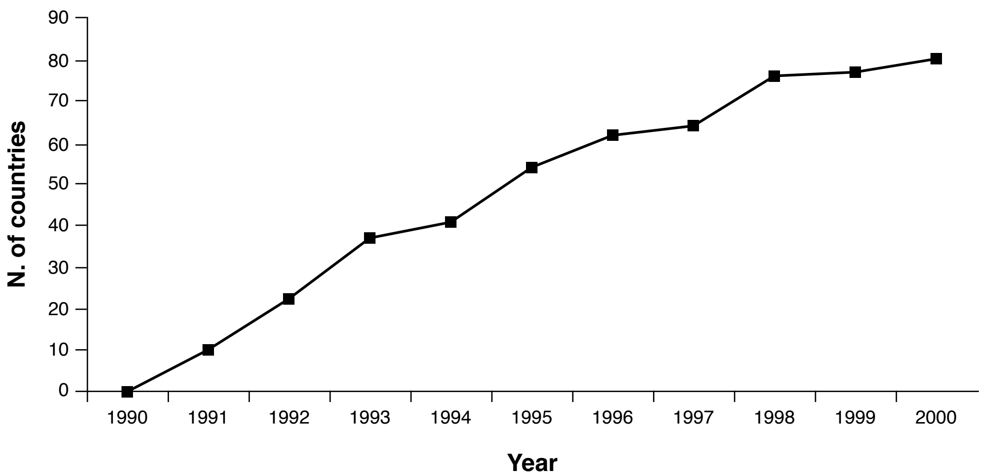
Source: IMF, 1998, tableA5.9 (p. 187).

A final development in the wider context of the global financial system that will be discussed here was the increasing 'technocratisation' of the policymaking process. This can be attributed to the rise of neoclassical economics which was mentioned above. Among relevant policymakers the view emerged that public monetary and financial authorities (central banks and banking supervisors) should be independent from the regular representative democratic process and that macroeconomic policies should be guided by fixed rules. Gill has labelled this development neoliberal constitutionalism.[125] With respect to central banks, the rise in

[124] Unfortunately, data for the UK is not available (making the latter possible explanation hard to verify).

independence (to be precise: legal changes in central bank charters geared towards greater independence) is shown in figure 3.3 below. In the 1970s and 1980s only eight countries made statutory changes towards higher central bank independence, so these years are not included in the figure. Polillo & Guillén (2005) argue that the rise can mainly be explained by pressures resulting from globalisation, for example the IMF pushing countries towards central bank independence.[126]

Figure 3.3 Cumulative legal changes towards higher central bank independence



Source: Polillo & Guillén, 2005, figure 1 (p. 1771).

The 1982 – 2005 period consequently saw significant changes in the market structure within the global financial system. These were brought on by shifts in governance at the domestic level (deregulation), specifically relating to the financial markets. The shifts in governance in the policy domains of bank capital adequacy standards and the resolution of sovereign debt crises are discussed in the following two chapters. For now, it may be noted that in many areas of finance there was a shift to less stringent, market-oriented forms of governance allowing market participants access to new market segments and countries. Furthermore, there was an increasing 'technocratisation' of policymaking, insulating financial policymakers from wider stakeholder inputs.

[125] Gill, 1998.
[126] See also Rapaport, Levi-Faur & Miodownik, 2009 who use simulations to argue that the steep rise in central bank independence in the 1990s is a case of diffusion among policymakers.

Summary and concluding remarks

In this chapter, the broad trends and developments in the global financial system in the post-World War II period were discussed. In passing, the most important policymaking institutions, actors and ideas underpinning these developments were introduced. In this concluding section, this history is summarised, taking the analytical perspective that was developed in the previous chapter and focusing on the common threads in this concise history: financialisation on the one hand and the variety of responses to it within a multilevel governance framework on the other.

The starting point of the analysis was the Bretton Woods system. This was a pattern of governance that operated at the global level through a system of fixed exchange rates with the gold-dollar peg as an anchor. The system was supposed to be supervised by the IMF with the financial markets being restricted to the national level. It had a clear 'public' nature, as a multilateral agreement with an international organisation (the IMF) at its apex. Bretton Woods was stringent on both governments (they were constrained by fixed exchange rates) and private actors (which were faced with capital controls). However, the Bretton Woods system was not implemented as intended. Crucially, a loophole for financial markets was created in the form of the Euromarkets.

The emergence of the Euromarkets reflected in a way a national level response to the stringent governance of the Bretton Woods system and entailed an important change in the market structure. The stringency of Bretton Woods had given private actors the incentive to search for a less strictly regulated 'offshore' market. British public officials, on the other hand, had a preference to position London as a global financial centre. The interaction of these preferences in the close-knit British financial policy community led to the emergence of an 'offshore' financial market in London that was regulated with a 'light touch'. The Euromarkets were further fuelled by the loopholes in US restrictions on capital outflows (the IET and VFCR). As a consequence, the terms of competition were increasingly determined by activities in the – profitable – offshore financial markets.

As a result of this changing market structure, the inherent tension of Bretton Woods as a system of governance (the Triffin dilemma) intensified. On the one hand, abolishing the fixed exchange rate would increase the policy autonomy of states (especially the US), and therefore seemed attractive to public policymakers. Furthermore, public officials increasingly realised the potential of the Euromarkets as a source of funding for sovereign debt. Private sector actors, on the other hand, had a keen eye on the profits internationalisation could bring them. The Euromarkets consequently led to adjustments to the preferences of private and public actors (especially in the US). As the US was the dominant actor in the Bretton Woods system it could single-handedly decide its fate, and when the adjusted preferences came together in the US policymaking institutions it did just that: in August 1971 President Nixon declared he would suspend the link between dollar and gold. US capital controls were lifted a few years later.

The change in market structure that the Euromarkets entailed had thus worked through the policymaking process at the domestic level to cause a significant shift in the global level governance pattern. This shift was most pronounced on the stringency dimension: no longer were public and private actors constrained by fixed exchange rates and capital controls. This paved the way for further international expansion of the financial system (financialisation) in the 1970s, which had already been evident in the advent of the Euromarkets.

This internationalisation of financial markets had two – very different – effects on the preferences of actors. On the one hand, they tried to benefit from the expansion of global financial markets by creating an environment conducive to the financial sector. This was also supported by the advent of neoliberalism as the main mode of thought within the global financial policymaking institutions such as the G7. This ideological shift, combined with the preferences of both public and private actors, led to a wave of competitive deregulation of financial markets (for example London's Big Bang). This led to less stringent governance patterns for private actors.

At the same time, the further internationalisation of finance also led to adjustments in the preferences of public and private financial actors. Internationally active private actors developed an interest in international harmonisation of financial regulations. Convergence of domestic regulations became more important to reduce the administrative burden and 'level the competitive playing field'. On the other hand, public actors recognised the need for macroeconomic policy coordination in the context of an increasingly integrated global financial system and realised the risks (as had already become evident in the 1974 Herstatt Bank crisis) of a global financial system and adjusted their preferences accordingly. This led to the emergence of a number of global level policymaking institutions, such as the G7 and the BCBS, which subsequently set steps towards global level governance patterns such as the Concordat.

These global level policymaking institutions had an exclusionary membership of G7/G10 ministries of finance and central bankers and aided in the forging of a neoliberal consensus among public financial policymakers. This also had the consequence that financial policy was increasingly delegated to independent institutions (banking supervisors or newly independent central banks). The relevant policymaking institutions for public actors moved to the global level (e.g. the G7 and the BCBS) and became increasingly isolated from broader socio-economic debates. This is, for example, reflected in the observation by Baker that finance ministers favoured the G7 meetings because they were meeting like-minded policymakers with whom they had more in common than with their ministerial colleagues at home.[127] A close dialogue with the private sector was, however, maintained.

The demise of Bretton Woods as a governance pattern consequently gave a further impetus to a long trend of increasing internationalisation and cross-sector integration and expansion of the financial system. For example, the banking sector as a share of the economy grew in the G10 countries, often becoming a multiple of the GDP. With the increasing importance of 'finance' in both the daily lives of citizens and the macroeconomic performance of national economies, the power of private financial actors in the policymaking process also increased. The IIF as the global level representative of the internationally active financial sector played an important role in this, and became the main private sector counterpart in the policymaking process.

Since the 1980s this new constellation of preferences, global level policymaking institutions and ideological shifts has led to successful initiatives to establish new governance patterns in some policy domains (e.g. the Concordat) and the demise of old governance patterns in others (e.g. the marginalisation of the Paris Club when it comes to sovereign debt crises in emerging markets). To sum up, a multilevel and not always coherent ensemble has emerged with shifts across the different dimensions of governance in various policy domains symbiotic to changes in the market structure such as financialisation.

In the next two empirical chapters, a closer examination of this multilevel ensemble is undertaken in the policy domains of bank capital adequacy regulation and sovereign debt crisis resolution. This will lead to an explanation of the relationship between changes in market structures and patterns of governance that is also evident in the historical analysis above.

[127] Baker, 2006, p. 27

Chapter 4

Bank capital adequacy under the Basel Capital Accords

In this chapter the international policymaking process concerning bank capital adequacy standards since the 1980s is studied and related to the developments in the market structure of the banking sector. In doing so, this case study sheds light on the relationship between the market structure in the banking sector and the patterns of governance of bank capital adequacy. Banking has always been prone to periodic crises, the socio-economic costs of which have been significant. The average banking crises in the post-Bretton Woods period lasted for 2.6 years and led to a cumulative loss of GDP of 6.2 per cent.[1] The current crisis has seen the collapse of some high-profile banks (most notoriously Lehman Brothers) and required billions in state support and nationalisations to prop up many others. This has subsequently led to severe fiscal consolidation (budget cuts) in many states, having an impact on a wide range of public services and welfare arrangements. The governance of bank capital adequacy seeks to reduce these costs by ensuring the safety and soundness of the banking sector, but also has an important impact on the terms of competition for banks and the cost of credit in an economy.

The analysis in this chapter starts with the negotiations on the first Basel Capital Accord (Basel I) which were finalised in 1988 and traces the process onwards to the major overhaul that led to the second Basel Capital Accord (Basel II, agreed on in 2004). The development in this policy domain in the aftermath of the current crisis will be dealt with in the concluding chapter. Five core arguments will be made in this chapter.

First, it will be argued that the governance pattern for bank capital adequacy emerging in the late 1980s (reflected in the Basel I Capital Accord) can be characterised as an international level, public pattern of governance that was relatively stringent for banks. Basel I in the first instance applied to the members of the BCBS (which largely overlap with the members of the G10). The first dimension of this governance pattern could be categorised as 'international', not applying to all countries globally and also not to a specific region (in geographical terms). On the 'nature' dimension, Basel I is public, being implemented by public bank supervisors with limited room for (private) bankers' input. Basel I was stringent in the sense that it set a fixed 8 per cent capital charge against risk-weighted capital. This risk-weighted capital was calculated through five risk categories, hence constraining banks' flexibility in addressing risks in their balance sheets through economic capital.

Second, it will be argued that the policymaking process leading to this pattern of governance was centred on US public authorities with the BCBS in an auxiliary role. The preferences of US authorities were heavily shaped by the fact that the Latin American debt crisis had brought their banking system to the brink of bankruptcy and necessitated significant official refinancing of debtor countries to be saved (see also the next chapter on the Latin American debt crisis). Domestic political dynamics led to a push for more stringent regulation (increasing bank capital), while banks saw this as an opportunity for international harmonisation (and consequently not only levelling, but also virtually opening up the playing field). These preferences came together in policymaking 'institutions' dominated by the US (initially in the form of bilateral and later trilateral negotiations). Only late in the process did the negotiations move to the BCBS in earnest. Given this process, it should come as no surprise that US preferences with respect to the governance pattern largely prevailed. The yardstick in the policymaking process had been defined early on as ensuring the safety and soundness of banks *and* levelling the competitive playing field.

The third argument concerns the relation of the shifts in governance of Basel I to the terms of competition and market structure in banking. It will be argued that first of all the international harmonisation of capital adequacy standards that Basel I entailed promoted further internationalisation of the banking sector. It furthermore encouraged consolidation of the banking sector. As a consequence the inter-firm terms of competition changed in the sense that international players entered domestic markets (there was international market integration) and more direct competition now took place between larger institutions. Most importantly, banks gained an incentive to change their business model from 'traditional' relationship banking to more capital market-based activities that would not show up on the balance sheet (and hence not bear a capital charge). Banks developed complex risk management models to gain a competitive edge in this new market structure, for example based on Value-at-Risk (VaR) models. This significant change in market structure led to new challenges to maintain capital adequacy (also due to the 'gaming of the system' by banks).

This leads to a fourth argument: this change in market structure led to an adjustment of the preferences of both internationally active private banks and public supervisory authorities regarding the governance pattern. This culminated in the renegotiation of Basel I. The policymaking process for this renegotiation was concentrated in the Basel Committee as the main policymaking institution. While this gave the negotiations a more multilateral character, it also provided a fruitful lobbying avenue for representatives of the international banking community (most notably the IIF). The skewed argument pool this implied quickly led to a focus on 'market-based' approaches (i.e. based on internal models).

Looking at the first dimension of governance, the Basel II Accord represented a shift upward on the jurisdictional dimension. Already during the 1990s, Basel I had become adopted by more and more countries outside of the original G10 countries. Basel II formalised this shift

[1] Bordo et al, 2001, table 1 (p. 59). Based on a 56 country sample over the period 1973 – 1997.

upward by explicitly aiming for global implementation, for example reflected in the establishment of an Accord Implementation Group. On the second 'nature of governance' dimension, it will be argued that a shift took place towards a more private form of governance. Where Basel I set crude risk categories in determining risk-weighted capital, Basel II led specific groups of private actors to determine their risk-weighted capital through their own risk models. An important part of supervision was, as it were, handed over to private actors. The proposals for the use of internal risk models imply a shift to less stringent governance, as banks would have more leeway in conducting their business through the use of their own internal risk models. Consequently, a shift in the third dimension (for a specific group of banks) can be observed.

Fifth and finally, it is argued that the focus on market-based instruments like the Internal Ratings Based (IRB) approach can be explained by the relatively strong position of internationally active banks within the relevant policymaking institutions, and by an argument pool skewed towards market-based solutions among the participants in the policy community. Participants in the policy community were reluctant to bring up hesitations about the model-based approach. On the other hand, public sector preferences are reflected in the comprehensiveness of Basel II, e.g. by including operational risk despite fierce opposition of the private sector.

In developing these arguments, this chapter makes two main contributions to the overall objectives of the thesis, as well as to the existing literature (see also the discussion of the literature in the next section). First of all, by including the developments in market structures in the analysis, it becomes clear how governance and market structures are interlocked through the policymaking process. The internationalisation of the banking sector leads to private sector calls for international harmonisation, while official sector representatives seek to address the implications of international operations on financial system risk. This struggle is reflected in the policymaking process of both Basel I and II. Through the analysis presented in this chapter, a simultaneous explanation of the developments in market structure and shifts in governance pattern is provided. This is one of the main contributions to the existing literature, and to the overarching argument of this thesis.

A second contribution builds on the first: by showing the relationship between market structure and governance pattern – by means of the feedback loop from shifting patterns of governance (Basel I and II) to changing market structures in the form of capital market activities of banks – it becomes clear how public and private actors interact in a globalised market system. This aids our understanding of the changing power configurations between public and private actors in a time of financialisation.

This chapter is set up as follows. In the first section, the literature on the Basel process is discussed. This shows the nature of the contribution of this chapter's analysis. The negotiations on the first Basel Accord are discussed in the second section. This is followed by an analysis of the impact of Basel I on the market structure in the banking sector in section three. This section also works towards an explanation of the start of the negotiations on Basel II, which will be discussed in section four. The final section concludes with an analysis of the developments and some preliminary implications of this case for the argument set out in this thesis.

Analysing the governance of bank capital adequacy

The issue of banking regulation has been a fruitful avenue for IPE research from a variety of perspectives (as well as from adjacent disciplines such as Economics and Law). The literature discussion below starts with early accounts of the BCBS and the policymaking process on Basel I, followed by a discussion of the literature on the Basel II negotiations. Wood (2005) and Tarullo (2008) are contributions that cover both policymaking processes extensively and consequently cover the same ground as this chapter.

Reinicke (1995) provides an account of the Basel process as a sideline to his central story of the regulation of American commercial banks. He paints a vivid picture of the origins of the American push for international harmonisation of regulation in US domestic politics. However, the explanation for the emergence of Basel I in the international negotiations is less clear (perhaps unsurprisingly for a US-focused study). Reinicke points to the emerging consensus among central bankers on the issue of bank capital adequacy standards, which was formed in discussions from the late 1970s onwards. This consensus was a response to safety and soundness concerns, and could consequently be described as a functionalist response to market developments. It remains unclear, however, how he explains that the BCBS finalised the Basel Accord in the face of national divergence on capital adequacy standards.[2] He furthermore points to the increasing lobby of domestic banking constituencies to their banking supervisors for adjustments to the Accords in favour of national idiosyncrasies.[3] His account remains state-based, however, and is especially focused on the US.

Norton (1995) describes how the American push for a capital accord linked up in the BCBS with efforts in the European Union to harmonise capital requirements in the context of the European Union's common market project. In his account, this provided the rationale for reaching the Basel I Accord, while the US-UK agreement on capital adequacy standards served as an 'intervening catalyst'. Besides the fact that this seemingly underestimates the crucial importance of the US-UK agreement, a drawback of his study is that he fails to take into account market developments or the role of private actors in the policymaking process. Coming from the law discipline, the focus of his contribution understandably lies with the regulators.

In a number of contributions, Kapstein has provided a largely functionalist account of the emergence of the Basel process and Basel I.[4] Market failures that emerged with the interna-

2 Regulatory arbitrage seems to play a role in his account, Reinicke, 1995, p. 165.
3 Reinicke, 1995, p. 164.
4 Kapstein, 1989, 1992 and 1994.

tionalisation of banking led to a need for international cooperation. Supervisors responded to this by developing the Basel Accord. Kapstein provides an intergovernmental account (which he admittedly sets out to do) and pays relatively little attention to the political context in which policymaking takes place and to the different interests within the banking sector and between supervisors. His account does not elaborate how the preferences for certain governance patterns of both public and private actors are shaped by the international integration of the market.

Oatley & Nabors (1998) respond to a number of the drawbacks of Kapstein's functionalist account. They provide an interest-based explanation for the emergence of Basel I, focused specifically on the interests of the American banking sector and exercise of American power (through the threat of exclusion from the US market) in pushing the Accord. What this account underemphasises, however, is the impact of the internationalisation of the banking market on the governance pattern – a drawback shared with Kapstein's account. Although the US policymaking process certainly was crucial for the development of the Accord, the international negotiations were not simply a deferral to US preferences.[5]

A bridge between analyses of Basel I and II is provided by Singer (2007). He aims to explain regulators' preferences for global financial regulation, and uses capital adequacy regulation as one of his 'successful' cases. He explains the outcome of the international negotiations on the Capital Accords as the result of a balancing act between stability and international competitiveness.[6] However, this analysis gives limited attention to the emergence of international actors in the policymaking process concerning Basel II. As he seeks to explain regulators' preferences, it is also a state-oriented analysis.

Claessens, Underhill & Zhang (2008) argue that the policymaking process leading to Basel II can be explained by an exclusionary policymaking community with substantial private sector influence.[7] The developments were thus to a large extent determined by a congruence of specific preferences and a specific policymaking institution. This led to an Accord that accommodated internationally active banks, while potentially having the effect of hampering other types of banks and developing country borrowing. In a similar vein, Tsingou (2008) points to the importance of the G30 and IIF as respectively hybrid and private actors in the policymaking process.

Kette (2009) focuses on the ideational factor in his explanation of the Basel II negotiations. According to Kette, the paradigm shift represented by Basel II is a shift from quantitative rule-making towards a model of supervision based on dialogue (as in the second pillar of Basel II). In the terminology of this thesis this would be called a shift towards less stringent

[5] See e.g. Chey, 2006 for an analysis of the role of Japanese public and private actors in the negotiations. Off-the-record interview sources from the 1990s furthermore contradict Oatley & Nabors' account of US success in pushing regulatory costs on competitors.
[6] Singer, 2007, p. 66.
[7] See also Claessens & Underhill, 2010.

governance and likely also a shift in the nature of governance towards more mixed public-private governance (from public governance). Importantly, he claims these shifts in governance came about through a policymaking process that was also focused on dialogue and learning. Through their interaction with stakeholders, supervisors learned the 'better way' of setting capital adequacy standards in the form of Basel II. This learning was necessary due to the complexity of modern financial systems and the information asymmetry between private financial firms and supervisors. Kette gives scant attention to the skewed nature of this 'learning' and the politics of the negotiations, however. In light of the current crisis, whether Basel II is the 'better way' of setting capital adequacy standards can be seriously doubted.

An analysis from a critical IPE viewpoint is offered by Bieling & Jäger (2009). They see Basel II as the result of demands from large international banks for more market-based regulation. Their focus is on the EU, where the European stance in favour of more market-based forms of banking supervision is a result of a coalition of transnational financial corporations and neoliberal European institutions. This coalition saw the negotiations in the BCBS as an opportunity to promote the transition to an Anglo-Saxon style of capitalism.[8] Although they do acknowledge accommodation in the policymaking process of, for example, SME concerns, they emphasise that the thrust of the accord is driven by transnational financial forces and focus on the impact this has on the socio-economic structures in the real economy of the EU.

Coming to the analyses that span both the Basel I and II negotiations, Wood (2005) provides an excellent discussion of the negotiations in the BCBS. His account follows Oatley & Nabors in pointing to the influence of American banks in internationalising domestic standards and levelling the playing field, as well as to the threats by the US and US-UK of exclusion from their market that were necessary to push through the final Accord. With respect to the negotiations on Basel II, Wood points to the private sector pressure that was crucial in starting the negotiations. He continues to discuss a number of disputes between the members of the G10 that were pivotal in shaping the Accord. In both policymaking processes, conflicts and power politics of the members of the G10 are consequently essential in the explanation of the outcome. Although he does give attention to the role of private actors, the thrust of his analysis is state-based, as he aims to expose the politics underpinning the supposedly technocratic intergovernmental negotiations.

An insightful and policy-oriented account of the BCBS negotiations on the Capital Accords is provided by Tarullo (2008).[9] He concludes (narrowly framed) "that Basel II's detailed rules for capital regulation are not an appropriate basis for an international arrangement among banking supervisors"[10] and criticises the influence of commercial and bureaucratic interests on the Basel II negotiations. He mostly provides a descriptive account, but does show how the BCBS' members were drawn into designing the optimal bank regulatory regime from a theoretical

[8] Bieling & Jäger, 2009, p. 88.
[9] Tarullo is currently serving as a member of the Board of Governors of the Federal Reserve.
[10] Tarullo, 2008, p. 5.

perspective under the umbrella of the IRB in a process resembling groupthink (which led to the exclusion of other options). This process was largely driven by the Federal Reserve and the private sector in Tarullo's (somewhat US-centric) account. This set the yardstick for the outcome of the policymaking process, with regulators stumbling along in the process without fully knowing which problems they would face in designing a solution which would measure against this yardstick.

Although much of this literature provides a base to build upon, a contribution can be made by extending the analyses to both market structure and governance pattern. Many of the aforementioned studies are state-based, and do not give adequate attention to private actors and developments in the banking market. The analysis provided here will overcome this dichotomy and show how public and private actors operated in a state-market condominium. Taking the developments in the policymaking process and in the terms of competition into account will allow for a better understanding as to why certain preferences for renegotiation of Basel I emerged and how these interacted with policymaking institutions and group processes to lead to Basel II.

Obviously, another contribution of this chapter lies in extending the analysis from the Basel I process to the Basel II process, or vice versa by providing the historical background to the Basel II process in an integrated analytical framework. This shows how the feedback loop between market structure and governance pattern operates and hence provides a richer explanation of the developments than by focusing on one single episode. In the following section, the first stage of these negotiations will be analysed: the negotiations leading to Basel I.

The onset: preliminary international coordination and confrontation resulting in Basel I

In the previous chapter, it was already noted that with the internationalisation of banking, capital adequacy ratios had declined and the capacity of national supervisors to successfully implement domestic standards was diminished. This had led to tentative discussions among supervisors on capital adequacy in light of the dangers to the safety and soundness of banks these developments entailed. Although in most cases the increasing interest in capital adequacy did not result in formal capital requirements, bank supervisors asked banks to provide them with information on their capital adequacy ratios.[11] These tentative discussions among bank supervisors received an important impetus from the Latin American debt crisis. This put the spotlight on the internationalisation of the banking sector and the broad decline in capital adequacy. Supervisors noted that the potentially disastrous effects of the Latin American debt crisis on the banking sector was not because of circumvention of supervision,

[11] Tarullo, 2008, p. 40-41.

but because the current governance pattern did not prevent these new risks from being taking with adequate insurance against potential hazardous consequences.[12] The new international banking environment apparently posed more challenges than the Basel Concordat was able to counter.

In addressing the Latin American debt crisis, it was also underscored how different approaches taken by supervisors could affect international competition in the global banking market. Notably, Japan chose to shoulder the burden of the bad debts of the domestic financial sector by changing the tax code to allow for the deduction of a portion of the loan losses.[13] This further enhanced fear of the international competitive power of Japanese banks, which was already riding high at the time.

The American approach to the crisis, on the other hand, implicitly meant promoting IMF funding of the debt-laden emerging markets to ensure American banks loans were eventually repaid.[14] In the US, especially in Congress there was a lot of resistance against this US approach of 'bailing out' money centre banks, however. The required capital increase for the IMF (of which the increase of the American quota would have to be approved by Congress) provided the opportunity to voice this resistance. Reinicke quotes the chairman of the House Banking Committee in 1982 commenting: "At a time when millions stand in unemployment lines and thousands of small businesses are filing bankruptcy petitions, the idea of an international bailout for adventurous U.S. bankers may not be the most popular item on the legislative agenda."[15] However, House and Senate realised that not agreeing to the IMF quota increase could lead to further economic turmoil, which would hurt American exports. Therefore a deal was made where large-scale official refinancing of the debtor countries would be enabled through an IMF quote increase, while at the same time the American banking sector would face stiffer regulation to avoid political backlash in domestic constituencies.

American regulators were divided on the issue of stricter regulation, with especially the Fed backpedalling. Federal Reserve Chairman Paul Volcker seemed closely aligned with private sector preferences by warning against excessive regulation and pointing to the deterioration in the international competitive position of US banks additional capital charges would cause.[16] In an attempt to pre-empt legislative intervention, the US banking supervisors produced a rather bland five point plan, which called for further analysis of capital adequacy in relation to (international) portfolio diversification and greater transparency. It did not include formal capital adequacy standards, however.[17]

The US banking sector resisted the push from Congress even more forcefully, with the vice chairman of Chase Manhattan Bank stating "a tighter web of administrative controls

[12] Wood, 2005, p. 68.
[13] Kapstein, 1994, p. 103.
[14] See also the next chapter for a more elaborated analysis of the 1980s debt crisis.
[15] Chairman St. Germain, 21 December 1982 quoted in Reinicke, 1995.
[16] See also Wood, 2005, p. 71-72 on the close association of Volcker with US bankers' preferences.
[17] Reinicke, 1995, p. 144.

around the foreign lending of banks, as some have suggested, would be unwise, unnecessary and counterproductive (…) Frankly, I don't really feel that we need a whole lot of new regulation to solve this problem."[18] Private sector representatives even rejected the modest five point plan of the US regulators, to the dismay of members of Congress.[19]

When bankers successfully challenged the authority of American regulators to set capital adequacy levels under contemporary legislation, the balance in Congress was tipped in favour of strict capital adequacy regulation.[20] The appearance of a bailout had to be avoided, which resulted in the 1983 International Lending Supervisory Act (ILSA) setting a capital adequacy standard for all US banks. The ILSA implied a domestically implemented supervisory regime for banks that would have imposed additional costs on the banking sector relative to its foreign competitors. Domestic concerns about the impact on the competitive position were alleviated by giving the Fed a mandate to seek international agreement on minimum capital adequacy standards.[21]

The initial impulse for a shift in the governance of bank capital adequacy to the global level was thus due to the interaction in the domestic US policy community between Congress, supervisors and banks. The changes in the market structure of banking that had occurred during the 1970s were responsible for this impulse in two ways. First and foremost, the internationalisation of bank lending to emerging markets had led to a global financial crisis. Western banks were brought to the brink of systemic failure, increasing the urgency for public actors to find a governance pattern that would ensure the safety and soundness of banks. Secondly, the internationalisation had led to a global – but as yet uneven – competitive playing field. On this global playing field, differences in domestic standards for bank supervision, as well as the processes used to ensure safety and soundness could lead to competitive (dis)advantages over banks in other countries. Furthermore, banks had an interest in ensuring the safety and soundness of their counterparts.[22] These forces combined to give (especially US) supervisors a preference for strengthening the international supervisory framework (pressured by public opinion), while the banks had a preference for encouraging international convergence of supervisory frameworks. This resulted in a dual focus on the 'safety and soundness of banks' and 'levelling the international competitive playing field.'

After adopting the ILSA, the US Congress mostly lost interest in the further process of bank capital adequacy standards.[23] It was now up to the Fed to propose negotiations on an international agreement on capital adequacy standards in the BCBS as a result of the domestic

[18] Quoted in Reinicke, 1995, p. 145.
[19] Reinicke, 1995, p. 145.
[20] Reinicke, 1995, p. 146-147. The fact that large money centre banks had in the meantime already improved their capital ratios was also likely a contributing factor.
[21] Oatley & Nabors, 1998.
[22] Off-the-record interview.
[23] In an off-the-record interview with a public actor 1992, it was mentioned Congress was not much involved in the negotiations.

compromise. Initially this was not very enthusiastically received by most other members of the BCBS. When Volcker laid out his plans in the BCBS in March 1984, they were "greeted with a yawn," as Kapstein quotes an insider.[24]

Although some BCBS supervisors were already working with the concept of risk-weighted capital adequacy standards, each had their own views on the necessity of formal, internationally coordinated capital standards. When the BCBS had initially worked on this issue (as mentioned in chapter three), it had resulted in an appeasement of all members: a definition of bank capital consisting of six tiers and risk-weighting of assets consisting of seven categories (in addition to the use of a gearing ratio).[25] This meant international harmonisation without adjusting national diversity in regulations, and the 'yawn' in response to Volcker was likely the result of this experience. Besides, the European Community had already embarked on their own supranational regulatory project (notably with a similar dual focus on soundness and competitiveness). The BCBS was thus reluctant to function as a policymaking institution whereas the US plans for international harmonisation could benefit from further development.

However, the Bank of England (BoE) was less sceptical towards US overtures than most BCBS members and willing to negotiate a bilateral agreement. They supervised the European financial capital with the largest presence of American banks, and more important had already moved to a risk-weighted standard (the American system was inspired by the UK one).[26] Hesitations about the development of harmonised regulation in the EU might also have played a role.[27] The private sector in both countries encouraged the creation of a bilateral deal, being aware of the competitive inequalities caused by different supervisory standards. [28] The negotiation of a bilateral accord would lead to a pattern of governance at the 'bilateral' level, comprising the two single largest global financial centres. Over the course of 1986, the US and UK silently engaged in negotiations.

Since both the US and the UK were already working with quite similar capital adequacy standards, they managed to reach an agreement fairly quickly, completing it in January 1987. One of the main steps forward in these negotiations was on the topic of the definition of capital, which would return in later negotiations. The bilateral US-UK agreement incorporated a risk-weighted approach, but had a simple two-tier capital structure. The latter meant a distinction between base primary capital (stocks, retained earnings, general reserves and some other items) and a second tier of limited primary capital including, for example, some types of subordinated debt. The second tier of capital could not exceed half of total base capital in counting towards the capital adequacy ratio.

[24] Interview quote in Kapstein, 1994, p. 108.
[25] Norton, 1995, p. 184 – 185.
[26] Wood, 2005, p. 75-76.
[27] Kapstein, 1992.
[28] Reinicke, 1995, p. 168.

The US-UK agreement served as a strong incentive for other members of the G10 to overcome their initial reluctance and come to a substantive multilateral agreement.[29] There was the not-always-subtle threat emanating from the US-UK agreement of closure of the world's two foremost financial centres to banks under diverging supervisory standards. If the other G10 members were to be able to influence the final Accord (e.g. regarding national exceptions and competitive interests) they needed to get involved.[30] The BCBS consequently decided in January 1987 to negotiate an Accord, for which the US-UK agreement provided a strong foundation.[31]

The first focal point for the US and the UK, however, was the third financial superpower: Japan. At the time, Japanese banks were seen as a major competitive threat to the Western world, and part of their competitive advantage was thought to be beneficial supervisory arrangements. During the early 1980s, the Japanese recognised that an overly large deviation from the trend in other G10 countries could lead to friction with other countries, and they had already started designing their own capital standards.[32] To imitate the other countries' standards without actually raising capital standards for Japanese banks, banks were allowed to count 70 per cent of unrealised stock market gains as capital.[33]

The US-UK agreement encouraged the Japanese supervisors to continue working on a capital standard, especially when the threat of exclusion seemed to materialise. The banking licenses for several Japanese banks wanting to enter the US market were postponed, supported by several policy statements by US and British policymakers aimed at getting the Japanese supervisors to fall in line with the Anglo-Saxon discussion. This brought Japan to the negotiating table even though the Ministry of Finance of Japan did not believe higher capital levels were necessary for Japanese banks.[34]

In the subsequent trilateral negotiations, one of the key topics for the Japanese supervisors was the definition of capital to be used in calculating capital adequacy. More specifically, they sought to continue the possibility for Japanese banks to include unrealised profits on shareholdings. With the Japanese initially aiming for 70 per cent of these gains to count as capital (as was already domestic practice), the US and especially the UK objected (because their banks were not allowed this practice under domestic accounting rules).[35] This issue was so important for the Japanese banking sector that their association even petitioned the Fed directly on this issue.[36] The bargaining among the three states resulted in a 45 per cent weight

[29] Off-the-record interviews with public actors, 1992.
[30] Wood, 2005, p. 74 - 81.
[31] Reinicke, 1995, p. 171.
[32] Chey, 2006, p. 68.
[33] Chey, 2006, p. 70. The 70 per cent figure was based on past stock market volatility, but effectively leads to what Chey calls 'cosmetic compliance' when you compare it to the (later) Basel standard.
[34] Chey, 2006, p. 68.
[35] Wood, 2005, p. 78.
[36] Reinicke, 1995, p. 172.

towards capital of unrealised gains. This result was quite agreeable for the Japanese, since their huge stock market gains during the 1980s ensured that a 45 per cent weight would allow their banks, among other things, to reach the 8 per cent capital adequacy ratio.[37] This was the ratio that was starting to emerge as the standard in the parallel BCBS negotiations. By September 1987 the three countries reached a trilateral agreement, confirming the risk-weighted assets approach and the two-tier capital structure of the bilateral accord.

After the trilateral accord was reached, negotiations moved to the BCBS in earnest. Smaller BCBS members complained about this process, among them Markus Lusser, vice-president of the Swiss National Bank, who remarked that "the willingness to co-operate internationally could suffer damage in the long run."[38] The late appearance of the BCBS as the policymaking institution had meant the exclusion of the voices of the small G10 countries in the policymaking process so far.

In the subsequent negotiations, the 'non-triad' members of the BCBS sought measures to accommodate specific issues relevant to their domestic banking constituency, or complained about exceptions for others. With the broad outline of the Accord already fixed by the trilateral agreement, the main bone of contention was the definition of capital and what could be counted as it. The Germans specifically pushed for a stricter definition of capital. For many other countries, the interest of domestic banking constituencies took the lead, with the French, for example, pushing for the inclusion of loan loss reserves (which the French banks had accumulated to a significant amount in the aftermath of the Latin American debt crisis).[39] The second tier of capital proved useful here to accommodate national differences, while maintaining a strict capital definition for the first tier.[40]

The BCBS banking supervisors reached broad agreement by December 1987, and put out a 'consultative paper'. During this consultative round, the BCBS consulted with non-G10 banking supervisors while domestic banking regulators used it as a formal opportunity to discuss the draft accord with their banking industry.[41] The consultative round only led to minor revisions, with the largest ones being championed by the US (inclusion of perpetual non-cumulative preferred stock in tier 1 capital) and France (same risk weighting for bank credit extended to all banks in the OECD, not only OECD home country banks).[42] The reaction of the private sector in the various countries was relatively subdued, because they hoped they could satisfy their preferences in the national policymaking institutions where the implementation of the Accord would be carved out (mistakenly, it turned out).[43]

[37] Chey, 2006.
[38] Cited by Reinicke, 1995, p. 169.
[39] See Underhill, 1997, p. 30.
[40] Off-the-record interview with a public actor, 1998. See also Reinicke, 1995, p. 173 and Tarullo, 2008, p. 57.
[41] Responses by the private sector might have been limited because they were taken by surprise when the BCBS managed to reach an international agreement (off-the-record interview, 1992).
[42] Tarullo, p. 55 (footnote 16).
[43] Reinicke, 1995, p. 175.

In July 1988, the final accord (with the title 'International Convergence of Capital Measurement and Capital Standards') was agreed on by the governors of the G10, adding a strong global level component to the governance of the banking sector. The BCBS explicitly linked the issue of safety and soundness of the banking system and the issue of levelling the competitive playing field. The Accord comprised some 25 pages with rules for capital adequacy, and its implementation phase ran until 1992.

The Basel I Capital Accord is consequently a risk-weighted capital adequacy standard reflecting a number of political compromises and the situation in the global banking sector at the time. It uses two tiers of capital, the first (core capital) consisting of shareholders' equity and disclosed reserves. The second tier consists of various other sorts of secure capital, such as revaluation reserves, loan loss reserves, hybrid capital instruments, undisclosed reserves and subordinated debt. The Japanese lobby for inclusion of unrealised gains on securities is reflected in the restriction that asset revaluation reserves that take the form of latent gains on unrealised securities are subject to a discount of 55 per cent. Banks are required to hold 8 per cent of capital against the risk-weighted outstanding assets (with a minimum tier 1 capital/asset ratio of 4 per cent).

Risk weights were assigned according to class of asset and varied from 0 per cent (cash, OECD government debt, local currency government debt) to 100 per cent (claims on the private sector, claims on non-OECD government in foreign currency). These risk weights clearly show the origins of the Accord in the 1980s Latin American debt crisis, with loans to non-OECD countries indiscriminately weighted at 100 per cent as compared to 0 per cent for OECD countries' sovereign debt. The fact that none of these non-OECD countries sat at the table during the negotiations will surely have made this feature less controversial in the negotiations. At the same time, this also provides banks with an incentive to lend to OECD countries instead of to non-OECD countries. The market position of state debtors from OECD countries thus improved. The Accord also dealt with certain types of off-balance sheet items like lines of credit and underwriting facilities by counting them as assets (with a discount), and then putting them into the 100 per cent risk category.

A number of points are noteworthy in the policymaking process and resulting Accord. First of all, Basel I implied an important shift 'upwards' in the jurisdictional dimension of governance. The G10 countries basically agreed to a governance pattern emanating from the BCBS, and this was later followed by many non-G10 countries. For the first time, the globalisation of the banking sector was followed by a shift upward of governance to the international level. On the second dimension of the nature of governance, Basel I is mostly public. It was implemented by public bank supervisors without much room for (private) bankers' input. The Accord was negotiated by public sector actors in the BCBS, without significantly enhancing or reducing private sector influence on the supervision of banks.

On the stringency dimension, Basel I did entail a restraint of banks' room for manoeuvre (as had been the intention from the start), especially compared to the unregulated Euromarkets. For many countries, the implementation of formal capital adequacy standards was new, and the required level of capital at 8 per cent was higher than it often used to be. On first sight, also the calculation of the required capital was relatively inflexible with the fixed categories and weights having the consequence of constraining banks' flexibility in addressing risks in their balance sheets. However, as will become clear in the next section, this proved less restraining than it might appear.

This outcome in the sense of shifting patterns of governance can be explained by the particular interaction between preferences (interests), ideas and policymaking institutions in the policymaking process. The discussion above showed that the preferences of US authorities were heavily shaped by both the fact that the Latin American debt crisis had brought their banking system to the brink of bankruptcy and by domestic political dynamics that led to a push for more stringent capital adequacy standards. Banks, on the other hand, saw this as an opportunity for international harmonisation (and hence not only levelling, but also virtually opening up the playing field). In the international policymaking process, a consensus had already started to emerge pointing to a lack of (risk-weighted) capital as the problem, focusing the discussion around the idea of a risk-weighted capital adequacy standard. Moreover, the US steered the policymaking process to institutions conducive to its views. These preferences consequently came together in policymaking 'institutions' dominated by the US (initially in the form of bilateral and later trilateral negotiations), although in the final phase of the negotiations it moved to the BCBS in earnest.

In the following section, the impact of Basel I on the terms of competition and market structure is discussed. Furthermore, the adjustments to the Accord over the course of the 1990s are discussed.

The interlude: Basel I feeding into the market structure

Basel I provided a number of incentives for actors, changing the terms of competition in the market (and consequently the market structure). The Accord gave an impetus to the further internationalisation of the banking sector because the costs of doing international business were reduced by harmonisation. This meant new entrants on domestic markets, or, looking from the global market perspective, rising inter-firm competition. A second impact on the terms of competition was that Basel I provided incentives for banking market consolidation, again affecting inter-firm competition. Thirdly, the Accord provided an incentive for market innovations such as the use of capital market instruments and off-balance sheet activities. This changed the nature of the banking business and blurred the line between different market segments in the global financial system.

First turning to the internationalisation trend: this had already been going on for several decades in the wider context of financialisation (as has been discussed in chapter three). As can be seen in table 4.1 below, the internationalisation of the banking sector held steady over the course of the 1980s, and accelerated for most countries in the second half of the 1990s (some years after the phasing in of Basel I). The envisaged 'levelling of the playing field' seem to have had a limited immediate impact on internationalisation, therefore.[44] On the other hand, it could also be noted that the Latin American crisis had not led to a retreat to the home market (unfortunately data for the 1985 - 1990 period, which shows a reduction, does not include emerging market claims). Furthermore, some private sector representatives did report in 1992 that international competition was more intense due to Basel I.[45] In general, banks were increasingly active on international markets and consequently experienced increasing international competition as well.

Table 4.1. Foreign claims of banks in selected OECD countries (% GDP)[46]

Country	1983	1985	1990	1995	1998*	1999*	2000	2005
Belgium	7	13	10	13	14	152	172	239
Germany	5	9	9	11	18	80	98	100
France	13	16	9	10	13	58	59	83
Italy	3	4	3	5	5	22	26	20
Japan	5	14	12	9	8	24	25	36
Netherlands	5	11	9	16	35	98	105	260
UK	18	18	9	21	23	58	72	108
US	6	5	2	3	3	7	7	8
Sweden	3	3	3	3	4	35	59	137
Switzerland	16	29	18	19	31	359	386	519

* Note: break in data series, see footnote Source: BIS consolidated banking statistics, table 9B

A second trend in the banking sector was consolidation, leading to ever bigger financial conglomerates (see table 4.2). This trend could be the result of the increasing competitive pressure resulting from the supervisory harmonisation under Basel I.[47] This had important consequences for the global banking markets. Consolidation provided economies of scale in risk management departments, allowing further specialisation and sophistication.[48] The rise of the use of VaR models to get detailed risk assessments of the positions of banks was a reflection

[44] In an off-the-record interview (1992) a private actor claimed that the levelling effect of Basel I was limited. See also Wood, 2005, p. 88-89.
[45] Off-the-record interview with private actor, 1992.
[46] Between 1998 and 1999 the definition of 'foreign' was widened by the BIS (to include emerging markets). This leads to a 'jump' in the trend. The table shows the increase in the international position of banks notwithstanding this 'jump'.
[47] Llewellyn, 1989, p. 46, paraphrased in Wood, 2005, p. 90. Groeneveld, 1999 inter alia also points to the influence of international harmonisation of regulation.
[48] This was also noted by supervisors at the time, e.g. Bank of England, 13 March 1992, p. 5. In light of the 2007-2009 events, sophistication almost sounds ironic, however.

of this. For example, JP Morgan reached a wide audience with its RiskMetrics service based on VaR models (promoted extensively from 1994 onwards).[49] This development shows the increasing consensus within the banking sector (especially large US banks) that these kinds of models were the right way to assess banks' riskiness and hence their necessary capital buffer.[50]

Table 4.2. Banking sector concentration (five biggest banks as % of total assets)

	1985	1990	1995	1999
Belgium	48	48	51	77
France	46	43	41	43
Germany	n/a	14	17	19
Italy	n/a	29	32	48
Netherlands	73	73	76	82
Sweden	81	83	87	88
UK	n/a	n/a	28	29
US*	17	20	26	37**

* Concerns biggest 10 banks ** Data for 1998
Source: ECB, 2000, table 2.1 (Europe) and Rhoades, 2000, table 15 (US)

The most direct – and arguably most important – response to Basel I was the rise in the use of off-balance sheet instruments. Off-balance sheet activities (specifically those that were not included in the consolidation measures in Basel I) like securitisation became more interesting as they carried only a limited or no capital charge at all. This further fuelled a proliferation of complex financial instruments and increased the importance of derivatives trading. An off-the-record interview source from a large internationally active bank even went as far as to cast doubt on the market efficiency of these financial innovations, instead pointing out that they mainly exist to address 'regulatory inefficiencies'.[51] In general we can say that there was a trend towards an originate-to-sell model, where banks made their money from fees instead of from interest rate spreads. Table 4.3 below reflects this trend at G10 banks. This changed the terms of competition by blurring borders between market segments and rewarding those banks that were able to compete across a number of market segments (e.g. through capital market access).

[49] Holton, 2002. Prior to 1994, JP Morgan had used this model itself.
[50] In an off-the-record interview one private actor stated "I believe in VaR models because I don't think the regulators have a better idea (…) I think the JP Morgans, the Goldmans and the Merills do - as much as anyone can – understand their risks."
[51] Off-the-record interview with private actor, 1992.

Table 4.3. Non-interest income as % of total income for G10 banks[52]

	1980	1985	1990	1995	2000	2005
Belgium	n/a	18	18	29	49	40
Canada	n/a	n/a	30	33	53	51
France	n/a	n/a	23	46	61	62
Germany	20	21	27	21	36	34
Italy	n/a	26	22	20	36	32
Netherlands	26	26	28	33	47	46
Sweden	26	31	24	35	57	57
Switzerland	48	47	49	57	63	61
US	25	30	30	32	40	41

Source: OECD banking statistics

Next to the changes in the terms of competition discussed above, which were reflected in the developments in market structure, on the regulatory front the European Union continued its efforts at supranational supervisory convergence. Supervisors had already gone beyond the Banking Directive, which was mentioned in chapter three. Reflecting the close ties and good cooperation between bank supervisors (often central banks), they had panned out agreements on how to deal with differences in supervisory approaches in different countries.[53] After implementing the Basel Accord, European supervisors continued harmonisation by looking at market risk (in addition to the traditional credit risk focus of Basel I).

This European lead on this issue was a result of the specific market structure in continental Europe. Where in the US (and in countries whose financial regulation was similar to the US system) the Glass-Steagall Act separated commercial banking from investment banking, no such separation existed in continental Europe. This meant continental European banks often traded in securities within the same entity that also accommodated the traditional banking activities. They were consequently confronted not only with traditional credit risk (the risk of a creditor defaulting), but also with market risks (the risk of a sudden decline in the value of securities held by a bank). Capital market activities were thus already a continental European tradition in 'universal banks'.

Since Basel I was only a minimum standard, there were no objections to the Europeans to address this development by adding a market risk element to the supervisory standard of the Basel I Accord. European supervisors thought such an addition necessary in light of the integration of the market for investment services that was strongly pushed by the private sector.[54] In 1992, therefore, the European Community agreed to a Capital Adequacy Directive (CAD). This translated Basel I into an EU directive, but as mentioned also included elements of market risk.[55]

Shortly after the European Community had agreed on a way to address market risk, the BCBS also revealed a consultative proposal for a market risk amendment closely mirroring the CAD proposal (which is not surprising as these amendments were developed in parallel).[56] The reason the BCBS followed the European lead and also developed a preference for adequate regulation in this field was the increasing desegmentation (meaning the banking and securities market became increasingly interwoven) in the global financial system that was now occurring globally – as also mentioned above.[57] With the increasing cross-sector integration in the financial system, market risks also become increasingly important for banks.

The 1993 BCBS consultative proposal especially requested comments from market participants, and this request was extensively fulfilled by market participants. In first instance, the BCBS proposed a standardised approach to market risk, akin to the approach of Basel I. According to private actors, however, the standardised approach was too simple. One particular strong demand from the market participants was therefore to use VaR models in the assessment of market risk.[58] The work on this amendment was finished by 1996, and it can be seen as an important step towards the regulatory philosophy enshrined in Basel II later on; the use of internal VaR models was allowed (within strict limits).[59] This also meant that Basel I plus the market risk amendment (Basel I.5) covered more and more of banks' activities, as the trading book was growing absolutely and proportionally.

This short description of the policymaking process concerning the market risk amendment offers an opportunity to take a step back and analyse how the trends in the terms of competition and market structure mentioned above influenced the preferences of actors with respect to the governance of bank capital adequacy.

For private actors, the market structure showed the emergence of a segment of globally active and increasingly large banks. These banks were diversified and made use of 'sophisticated' risk management tools based on models like the VaR model. Banks always had a preference for holding less (expensive) capital buffers, but with the models they could build the intellectual case for why Basel I overstated risks and hence the capital buffers. Moreover, the concurrent use of own (supposedly superior) models to calculate capital and a separate calculation for regulatory capital imposed an administrative burden on business. The large, internationalised banks consequently developed a preference for the use of internal models to determine regulatory capital and increasingly began to push for a full renegotiation of the Basel I Capital Accord.

[52] Numbers are for all banks and hence dilute those for the most sophisticated, internationally active banks. Data for Japan and the UK are not available in the OECD database.
[53] Off-the-record interview with public actor, 1992.
[54] Off-the-record interview with public actor, 1998.
[55] Wood, 2005, p. 95. The Capital Adequacy Directive formally passed into European law in March 1993, Directive 93/6/EEC.
[56] Off-the-record interview with public actor, 1998.
[57] Underhill, 1995.
[58] Off-the-record interviews with public actors, 1998.
[59] See Tarullo, 2008, p. 60-64 for an account of the policymaking process on the market risk amendment.

For public supervisors, the changing market structure also led to an adjustment of their preferences when the impact of Basel I on the market became clear. For example, a working group of the BCBS conducted a review study (finished in April 1999) analysing the impact of the Basel Accord on the banking sector as well as the broader macroeconomy.[60] This study roundly concluded that:

> *"The available evidence suggests, therefore, that the volume of regulatory capital arbitrage is large and growing rapidly, especially among the largest banks (…) there are indications that in many cases the effect [of securitisation] is to increase a bank's apparent capital ratio relative to the riskiness of its actual book, which is making the ratios more difficult to interpret and in some cases less meaningful."* [61]

The crude risk categories and their weightings influenced the incentive structure for the allocation of bank capital considerably. Basel I provided incentives for banks to move into business that would not increase their risk-weighted capital reserves. Furthermore, within each asset class, banks would have the incentive to seek the highest yield (and thus the most risky assets within the class). Public bank supervisors consequently realised that the Basel I governance pattern could underestimate risks in the banking sector.

In discussing regulatory capital arbitrage, a researcher from the Fed pointed out that it was mainly the large banks that were involved in this activity, through securitisation. Non-mortgage securitisation by the 10 largest US banks as of March 1998 was more than 25 per cent of the institutions' total risk-weighted loans.[62] He concluded:

> *"recent financial innovations and the 1997 Market Risk Amendment raise the prospect that such arbitrage may expand dramatically in the coming years (…) they highlight the importance of seeking ways to more closely align regulatory measures of risk with bank's true economic risks. Absent greater convergence, regulatory capital standards seem destined to become increasingly distorted by financial innovation and improved methods of RCA [Regulatory Capital Arbitrage] – at least for those large, sophisticated banks having the resources to exploit such opportunities."* [63]

In short, changes in the structure of banks undermined the aims of Basel I from a supervisory perspective. As an off-the-record public actor stated: "as they [the banks] were developing these more sophisticated tools they were both using them to manage their own risks, but it also shed light on where the Basel I rules were dramatically overstating or understating

[60] Jackson et al., 1999.
[61] Jackson et al., 1999, p. 26.
[62] Jones, 2000, p. 48.
[63] Jones, 2000, p. 51.

capital and therefore provided a nice toolkit to also arbitrage the hell out of Basel I."[64] This realisation led to an adjustment of public actors' preferences.

Although the market risk amendment was a step towards more risk-sensitive approaches under Basel I, large internationalised banks still found the standard increasingly constraining. The G30 played an important role in promoting a consensus in the international policy community that a new international supervisory model was necessary. Most important in this respect was their high-profile study 'Global institutions, national supervision and systemic risk'.[65] In this report, they also advocated the use of internal models. Although public actors in a first reaction to the report resisted the suggestion that the G30 provided a ready-made solution, they did accept the wider premises of the report and the need for further consultations.[66] Another prominent push came from the private sector through a 1998 report from the IIF working group on capital adequacy: 'Recommendations for revising the regulatory capital rules for credit risk' – a proposal to allow banks to use their own models.[67] These reports prepared the global level groundwork for a renegotiation of Basel I.

As mentioned above, both public officials and private sector representatives' preferences had already started to change. However, there were still prominent reservations among supervisors. In February 1998, the Dutch central banker Tom de Swaan (chairperson of the BCBS), delivered a speech at a high-profile New York conference on the future of regulatory capital stating: "the advances made by market participants in measuring and modelling of credit and other risks are potentially significant and should be carefully studied on their applicability for prudential purposes and might at some point be incorporated into capital regulation. But before we reach that stage, there are still formidable obstacles to be overcome."[68] De Swaan's term as chair was ending, however, and the emerging coalition for renegotiation received an important push when the chairmanship of the BCBS was handed over to William MacDonough of the New York Federal Reserve in June 1998.[69] The New York Fed had been one of the principal proponents of the model-based approaches.

Over the years the effects of Basel I on the terms of competition in the banking sector had severely changed its structure (for example, the rapid increase of securitisation) and hence its governance preferences. At the same time there was an increasing congruence of the outlook on the problem definition (regulatory arbitrage) and the possible yardstick (market-based risk management models) to measure the solution against among prominent international policymakers (consisting of these private sector representatives and several G10 banking

[64] Off-the-record interview with public actor, 2008.
[65] G30, 1997. See Tsingou, 2007 for a more extensive treatment of the role of the G30 in global financial governance.
[66] Off-the-record interview with public actor, 1998.
[67] Tarullo, 2008 discusses the importance of this report.
[68] DNB, 27 February 1998.
[69] The significance of the change in chairpersonship was pointed out to me by several off-the-record interviews with BCBS insiders, and is corroborated by Tarullo, 2008, p. 91.

supervisors). This culminated in the decision by the BCBS in July 1998 - in the first meeting under MacDonough's chairpersonship - that a new Capital Adequacy Framework would be negotiated.[70]

Renegotiating the Basel Capital Accord into 'Basel II'

As the above made clear, the renegotiation of Basel I started with a much higher degree of international consensus about the direction of the negotiations (e.g. reflected in the G30 position). The new Accord should strive for a comprehensive assessment of bank risks, based on internal risk management models. The renegotiation was also less driven by US domestic politics, with full negotiations starting at the level of the BCBS (without previous bilateral and trilateral negotiations) in response to changing preferences of G10 supervisors and large international banks.

This central position of the BCBS as the policymaking institution was also a new element in the negotiations. As will be shown below, this influenced the policymaking process in important ways through the skewed argument pool and close group coherence that the BCBS implies. On the other hand, supervisors increasingly felt they were meeting like-minded people, in contrast to discussions in their domestic policymaking processes.[71]

As a reflection of the firm entrenchment of the BCBS as the global level policymaking institution over the course of the 1990s, an important change vis-à-vis the negotiations on the first Basel Accord was the formal open consultation process managed by the BCBS secretariat. These consultations took place in three rounds, and were very transparent (the second and third consultative papers and the responses from interested parties can be found on the BIS website).[72] These formal consultations allowed private interest groups to petition the BCBS directly, as opposed to lobbying through domestic policymaking institutions. The latter had been the modus operandi during the policymaking process leading to Basel I.[73] In theory, the open consultations allowed many stakeholders to express their preferences to the BCBS. In practice this turned out rather differently, as will be demonstrated below.

With respect to the broader goals of the Basel Capital Accords, it appeared that supervisors aimed to add two policy goals to the new Accord (as the first consultative paper of June 1999 elaborated). The traditional two goals from the first Basel Accord (safety and soundness and competitive equality) were complemented by two other goals: a comprehensive approach to addressing risk and a focus on internationally active banks – although also being applicable to other banks. The first of these new goals seems to be based on the intellectual case that had

[70] Tarullo, 2008, p. 91.
[71] Off-the-record interview with public actor, 1992. Baker, 2006, describes a similar dynamic in the G7 meeting of finance ministers and central bank governors.
[72] www.bis.org. Unfortunately, the responses to the first consultative paper have not been published.
[73] Off-the-record interview, 1992.

been built for renegotiation (the superiority of VaR models in addressing different risks), as well is the increasing market integration. This comprehensive approach potentially also would influence the stringency of the Accord, as the more types of risk are included, the more banks are constrained in their activities.

Interviews with policymakers involved in the negotiations pointed to several issues of contention in the negotiations (both between different supervisors and between supervisors and the banking sector).[74] The discussion below will be structured around four such topics, which are representative of the wider political economy and governance issues related to the negotiations. The first topic concerns the use of ratings and internal models, the prime innovation of the new Accord. The second topic concerns operational risk, a new risk category that supervisors wanted to add to Basel II to live up to the aim of being a comprehensive risk approach.[75] The third topic was the treatment of specific national idiosyncrasies in the financial sector (including the issue of the implications of the new Accord for non-G10 countries). The fourth topic was the pro-cyclicality of the Accord, the extent to which the specific set-up of the Accord amplified the economic cycle.

The latter issue of pro-cyclicality can be addressed rather briefly for the purposes of this discussion. Pro-cyclicality concerns the fear that a risk standard based on ratings would squeeze credit in an economic downturn because of the deterioration of ratings, hence contributing to the further deepening of the downturn.[76] This issue was somewhat debated in the press coverage of the Basel negotiations. However, several BCBS insiders claimed that the committee never paid too much attention to it because every bank capital adequacy standard would be pro-cyclical in some form or other.[77] It apparently was mainly a bone of contention for academics, not so much for policymakers.[78]

The first consultative paper (CP1) came out in June 1999 and proposed a three pillar approach: capital adequacy requirements in the first pillar (with the 8 per cent capital requirement untouched), rules for the supervisory process in the second pillar, and the third pillar laying down measures with the aim of using market discipline to counter excessive risk-taking. CP1 stated unequivocally that "the new framework should at least maintain the current overall level of capital in the system."[79] It furthermore pointed out that the standardised (akin to Basel I) and model-based approaches should be consistent, in other words there would be no advantages in terms of capital requirements from using one approach over the other.

A first contentious topic in the ensuing policymaking process concerned the use of ratings and internal models. The first consultative paper introduced the use of external ratings,

[74] See the annex with data sources. The interview data is largely consistent with the accounts of Wood, 2005, and Tarullo, 2008.
[75] See also Power, 2005 on operational risk.
[76] See for example Griffith-Jones, Pratt & Segoviano, July 2003; Claessens, Underhill & Zhang, 2008.
[77] Off-the-record interview with public actor, 2007.
[78] Off-the-record interviews with public actors, 2008.
[79] BCBS, June 1999.

and mentioned the IRB approach. Only a very cautious step was taken towards model-based approaches, however. CP1 states that the BCBS "recognizes that for some sophisticated banks use of internal credit ratings (…) could contribute to a more accurate assessment of bank's capital requirement."[80] At the same time, the paper promised further steps in that direction, which was rather curious as many official actors involved had signalled that an internal ratings-based approach would demand significantly more study.[81] The Swiss supervisors, for one, apparently did not believe in the use of models for regulatory purposes at all.[82] However, it seems in the BCBS they focused on demanding higher capital requirements and not so much debated the model-based approach.[83] This could indicate the influence of groupthink with respect to the model-based approach.

The reactions to CP1 reflected disappointment on the side of the industry, which had a strong preference for the use of internal models. Several international associations, such as the IIF and the International Swaps and Derivatives Association (ISDA) pushed for more refined risk categories, and pointed out that internal ratings might be superior to external ratings in this refined approach.[84] The main external rating agencies (Standard & Poor's and Moody's) also responded hesitantly towards their newly assigned prominence in the governance pattern for bank capital adequacy. This can be attributed to their fear of newcomers on their turf[85] and thus provides a concrete example of how market participants try to influence the policymaking process and resulting governance pattern in order to maintain their competitive position. More importantly, both banking representatives and external rating agencies thus lobbied for using internal ratings rather than external ratings.

The second topic of contention concerned operational risk. It appeared that after having already included market risk in the Basel I Accord, the supervisors also wanted to include operational risk in the risk-weighted capital. This preference of supervisors follows from the regulatory philosophy of the Accord: to come up with a comprehensive risk-weighted standard as well as the experience of the collapse of Barings bank due to a rogue trader (Nick Leeson). This topic seemed to pit public supervisors working from a 'theoretical' perspective against the private banks seeking to reduce constraints, however. Since this type of risk ranges from rogue traders to earthquakes, it is hard to model and quantify in a market-oriented fashion. The banking sector was consequently hesitant about institutionalising this risk category in the Basel supervisory framework and preferred to address this type of risk in the course of 'normal business'.[86] When the negotiations had been launched, large internationalised banks had thought that the BCBS would work towards their own internal models, but now the committee

80 BCBS, June 1999.
81 Tarullo, 2008, p. 95/96.
82 Off-the-record interview, 2008.
83 Interview with representative of the Swiss public sector, 2008.
84 Off-the-record interviews with BCBS insiders.
85 The Economist, 27 November 1999.
86 Off-the-record interview with public actor, 2008. See also Tarullo, 2008, p. 98 and Wood 2005, p. 136.

proposed to add capital requirements for a new type of risk. Banks opposed this, claiming operational risk was already part of the regular business process (and thus did not need to be institutionalised).

The third topic concerned national idiosyncrasies and had already flared up before the first consultative paper was published. An important contentious issue was the treatment of mortgage loans.[87] Germany's peculiar mortgage market structure was accommodated by a supervisory system where commercial mortgages received a low risk weighting, and the Pfandbriefe from special mortgage banks received a low risk weighting as well. However, it was feared by other banks that both these measures would give German banks a competitive advantage in the international mortgage market. Germany was supported by the French and Spanish in trying to maintain the low risk weights, while the US together with the UK and Italy opposed it. The infighting between official delegations in the BCBS on these issues delayed the first consultative paper with several months. CP1 provided a compromise by leaving room for national exceptions on mortgages (or so the text was interpreted by the Bundesbank).[88] These preliminary skirmishes mainly reflected traditional, national level idiosyncrasies being protected by public officials.

The access to the BCBS of large, international banks paid off in the further policymaking process: many of the comments and discussions were taken aboard in the second consultative paper (CP2) of January 2001. CP2 was a much more detailed document (including supporting documentation it came to over 500 pages), but at the same time kept intact important elements from the first proposal such as the three pillar approach. Besides leading to a new round of discussions on the issues already identified in the first consultative round (such as operational risk), new issues were added to the discussion as well. Supervisors stumbled upon new issues as they went along.[89] The second consultative paper contained a crucial step in the direction of more market-oriented supervision mechanisms: it set out not one but two proposals for the use of internal ratings by the banks (the Foundational and the Advanced Internal Ratings Based approaches).

Extensive informal consultation with the private sector took place continuously at the domestic level and – more importantly – increasingly at the global level.[90] For example, interviews with the IIF revealed that there had been meetings at the highest level (i.c. Nout Wellink, chairman of the BCBS) concerning Basel II. These meetings were also initiated by the BCBS secretariat, which asked the private sector for 'help' in developing proposals.[91] CP2 also acknowledged this private sector influence: "The Committee has developed an approach

87 This has proven to be a sensitive issue in many emerging markets as well, according to several interviews with emerging market public actors in 2007/08.
88 Wood, 2005, p. 130.
89 Off-the-record interview public actor, 2008.
90 Off-the-record interviews with public and private actors, 2008. The extensive consultations with the private sector on global financial governance is also clear in the sets of interviews of the early and late 1990s.
91 Interview with IIF representative, 25 June 2008, Washington DC.

to regulatory capital that more accurately reflects a bank's individual risk profile. Work with industry associations and data collected through surveys have been essential to the development of a risk sensitive IRB approach."[92]

The effect of the extensive involvement of large international banks was most clearly reflected in the fact that the overall capital objective in CP2 only talked about maintaining the current level of overall capital for the standardised approach. For the 'sophisticated' banks, which could use the advanced approach, a temporary floor of a 10 per cent reduction in capital requirements during the first two years was set.[93] Such a reduction of capital would lead to a competitive advantage for large international banks over smaller competitors under the standardised approach.

Coming back to the four topics for discussion, supervisors obviously had incorporated private sector preferences with respect to risk models. The objections of credit rating agencies had been noted: national credit rating agencies were added as a second source of external ratings next to the traditional rating agencies. Furthermore, under the standardised approach, more risk categories were added to increase risk sensitivity. The extensive yet preliminary proposals for the IRB approaches proved the source of most discussion. The IRB was very much applauded by the largest international banks, which at the same time increased fears of the other banks that the Accord might hamper a level competitive playing field. The models of the IRB approach still had to be calibrated further, so it was unclear what the eventual effect of the IRB approach on bank capital adequacy levels was going to be.

To allay these fears, the BCBS conducted a series of Quantitative Impact Studies (QIS). Some months after the release of CP2, the second QIS was concluded. The results of this study are summarised in table 4.4 below, showing the change in capital requirements for diversified, internationally active banks (group 1) and smaller or more specialised banks (group 2). The outcome of the second QIS was surely problematic. Not only did it lead to overall capital increases (instead of maintaining capital levels, as was originally promised), the capital increase under the foundational approach was even higher than under the standardised approach. Clearly, further calibration of the models was needed in the eyes of private actors (and also public actors given the inconsistent results).

Table 4.4. Results of QIS2

	Standardised		Foundation IRB		Advanced IRB	
	credit	overall	credit	overall	credit	overall
Group 1	6	18	14	24	-5	5
Group 2	1	13				

Source: Tarullo, 2008, p. 112 (table 4.2)

[92] BCBS, January 2001, para. 93.
[93] BCBS, January 2001, para. 48 and 49.

Noteworthy (especially with the benefit of hindsight) was that in the academic literature the dangers of using a model-based approach were already pointed out.[94] The 1997 East Asian crisis had provided empirical backing of the main criticism on the models: the standard relationships on which these models are based break down in periods of financial crisis (as the current financial crisis once again demonstrates). The LSE's Jón Daníelsson also brought this to the fore in a response to CP2.[95] Alas, this seems to have been to no avail. Negotiations on the model-based approach continued undisturbed. Within the narrow policy community that was discussing Basel II, voices providing significantly divergent opinions seemed to have been ignored in a process of groupthink.

With respect to the second topic (operational risk), supervisors had not been deterred by private sector lobbying in making a specific proposal for an operational risk capital charge. CP2 set out an approach to operational risk that to some extent mimicked the whole Basel II approach: a basic approach using a relatively simple indicator, a standardised approach that offers more flexibility to the banks and an internal measurement approach.[96] This already allowed much more flexibility to the sophisticated category of banks, yet still met with strong opposition from the financial sector. Bankers feared that they would lose on the front of operational risk what they gained in market and credit risk, i.e. increased flexibility and a more tailor-made approach vis-à-vis capital requirements.[97] This might actually have been the objective of the supervisors. One BCBS insider provided a second-hand account in which operational risk was presented as a sort of backhander to European supervisors concerned about low capital requirements coming out of the IRB approaches.[98]

The third contentious topic of national idiosyncrasies was one of the points where supervisors 'stumbled upon' new issues. Using external ratings could have a negative effect on lending to Small and Medium-sized Enterprises (SMEs). Since few companies in Europe and Japan, especially SMEs, have such a credit rating, these would therefore get a 100 per cent risk weighting. This meant that lending to SMEs would become more expensive. With an election campaign in Germany underway, suddenly the issue of banking regulation rose to the highest levels of public attention. Chancellor Schröder intervened and made clear he would veto any European banking directive based on Basel II: Germany would not accept an Accord leading to higher borrowing costs for the *Mittelstand*.[99] This policy discussion was not prompted by private sector responses to CP2; SME associations only started responding to CP3.[100] In the BCBS German opposition was supported by Japan and other continental European countries.[101]

[94] Daníelsson, 2002 and 2008; Persaud, 2000.
[95] Daníelsson, 31 May 2001
[96] Tarullo, 2008, p. 108.
[97] Off-the-record interview with public actor, 2008.
[98] Off-the-record interview with public actor.
[99] Financial Times, 1 November 2001, p. 12.
[100] E.g. the submission to the BCBS by Eurochambres.
[101] Off-the-record interview public actor, 2008.

The topic of national idiosyncrasies was furthermore reflected in the treatment of credit card debts. Credit card debts are a substantial part of the balance sheet of especially American banks. A high risk weighting of these debts would force the US banking sector to hold relatively larger amounts of reserve capital than their global counterparts. Given the implications for the competitiveness of the US banking sector, this issue became a possible deal-breaker for the American representatives in the negotiations.

With difficult issues accumulating and given the aforementioned problematic quantitative impact results of the model-based approach, it is perhaps not surprising that in December 2001 the BCBS announced that it would need further work on the draft Accord before posting a new consultative paper.[102] It specifically mentioned that it would work on three issues. First, balancing the need for a risk-sensitive Accord that was sufficiently clear and flexible (so that banks could use it effectively). Second, ensuring that the Accord treats credit to SMEs appropriately. Third, calibration of the minimum capital requirements to bring about a level of capital that, on average, would be approximately equal to the requirements under Basel I (while providing some incentive to those banks using the more risk-sensitive internal ratings-based system, i.e. the possibility of lower capital requirements). Interestingly, the launch of an Accord Implementation Group was also announced, further strengthening the role of the BCBS in banking supervision and signalling that an agreement would be forthcoming.

The Committee also pointed out that the dialogue with market participants on several issues (such as securitisation) was still ongoing. And this proved to be very true: during June 2001 and with the release of the third consultative paper, the BCBS issued 10 substantive proposals on specific elements of the IRB approach for discussion and consultation with the banking sector.[103]

A Committee meeting in July 2002 delivered breakthroughs on several of the contentious topics.[104] It was decided that capital charges would only apply to unexpected losses (keeping most credit card debts out of the agreement). Credit card debts were thus to be covered by charging higher interest rates or bad loan provisions (as was already standing practice by banks). SMEs' concerns were accommodated by giving unrated companies a lower risk weighting than low-rated companies.[105] It became clear that the BCBS was bowing to some of the pressures coming from some national governments (Germany in the case of SMEs), politicians and the financial sector (on the issue of operational risk). These breakthroughs were subsequently put forward for consultation in the third consultative document.

After all these painstaking discussions, the third consultative paper (CP3) did not contain significant surprises with respect to the model-based approach, as adjustments and

[102] BCBS, press release, 13 December 2001.
[103] Tarullo, 2008, p. 114.
[104] BCBS, press release, 10 July 2002.
[105] This introduces a strange incentive into the Accords for low-rated companies to no longer apply for a rating and in doing so possibly reduce their costs of borrowing.

specifications had been floated for discussion beforehand (as mentioned above). With respect to the second contentious topic of operational risk, the supervisors had given in even further to the banking sector. This is because negotiations were bogged down on so many issues that some progress had to be made. Only a very low capital requirement was set, and this requirement could be easily circumvented by the banks. Consequently, governance on this specific issue shifted almost completely to the sophisticated banks themselves. National idiosyncrasies were mostly addressed through the breakthrough compromises mentioned above. Interestingly, the BCBS also claimed that the agreement on SMEs would diminish any pro-cyclical effect.[106]

As became clear from the discussion of the policymaking process above, the consultative paper process proved to accommodate the preferences of private sector parties. A closer look at the inputs received in the process helps to explain why. Due to the opaque and supposedly technical nature of the policy domain, the responses to the consultative papers are predominantly from international banks/bankers' associations or other financial services firms (see table 4.5 below). The second large group of responses comes from official banking supervisors from countries not represented in the BCBS. In about 30 per cent of the cases these were explicitly drafted in consultation with or on behalf of their domestic financial sectors. The other comments came from, for example, International Financial Institutions and individual academics (and curiously: one CSO from the Bronx).[107]

So although this open consultative process would make it very easy in principle for actors to join in the policy discussions, in practice the actors actually exerting influence were mainly the financial sector, banking supervisors and IFIs. This points to the effect of 'groupthink': apparently it is hard for other stakeholders to link up to the discourse in this policymaking process.

Table 4.5. 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: www.bis.org (author's classification)

[106] Off-the-record interview.
[107] As it turns out, this CSO might have delivered one of the most prescient comment letters: it pointed to the dangers of subprime mortgages. Inner City Press Community on the Move & Fair Finance Watch, 30 July 2003.

The BCBS itself had established a subcommittee in the form of the International Liaison Group. This group met with senior supervisors from 16 major (non-G10) countries to get early input on its discussions. Furthermore, regional groupings of bank supervisors were invited to participate in the work of BCBS subcommittees. This served to feed viewpoints from a wider set of countries into the BCBS itself 'without overburdening the efficiency of its work processes' (as an interview source put it).[108]

The G10 central bank governors approved the Basel II framework in June 2004. Basel II was to be implemented four years after it was initially scheduled and after seven years of consultations and negotiations. The Accord was far more complex than the Basel I version, and comprises over 250 pages of detailed regulations. As mentioned, the Accord consisted of three pillars. The first pillar set minimum capital requirements, and allows sophisticated banks to use their own internal risk models (the single most important demand of the internationalised large banks). This signified a shift in the pattern of governance towards more private forms of governance. For banks lacking the necessary sophisticated risk models, basically an adjusted version of the Basel I framework still applies. The second pillar provides for continued dialogue between supervisors and banks in order to deal with the idiosyncrasies of individual banks and situations. This institutionalises the position of banks in the implementation of the Accord by domestic level banking supervisors.[109]

The third pillar enhances bank transparency with the idea of exposing banks to the discipline of the market, again signifying a shift towards market-based governance. Interestingly, it seems that representatives of the financial sector took issue with the disclosure requirements under pillar 3. An off-the-record representative of the private sector claimed the disclosure might not enable the markets to compare risk profiles between banks. The private sector was therefore working on a self-regulatory framework to ensure a functioning third pillar.[110]

The formal implementation of the Basel II framework was planned to commence at the end of 2006. A new element in the implementation efforts of the BCBS was an institutionalised working group focused on the implementation of the Accord both in the G10 and in emerging markets. Its aim was to improve effective global implementation and it further entrenched the role of the BCBS as a policymaking institution.

Notwithstanding the BCBS' efforts, implementation first ran into some trouble in the parliamentary process in different G10 member states. The European Commission drafted the third Capital Adequacy Directive that passed the Basel II framework into European financial services law in record time. In response "the European Banking Federation hailed the 'unprecedented level of consultation' that preceded the proposals."[111] In the US, on the other hand, Congress took issue with the possible reduction of capital requirements as a consequence of Basel II. It went so far as to threaten to stop the implementation of Basel II in the US altogether, to the dismay of the IIF.[112] American banking regulators had already signalled in 2003 that they would delay full implementation of the Accord to 2008 and beyond, and would only apply it to about the 20 largest American banks. At the start of the current crisis, Japan was the first and only G10 country claiming to have fully implemented all pillars of the Basel II Capital Accord.[113]

The crisis knocked further implementation in other countries off the rails, and even led to significant renegotiations to a Basel III Capital Accord (see the discussion in the Conclusion). Although it thus cannot be established what the impact of Basel II on the terms of competition was, it is worth noting that a 2006 Ernst &Young study showed that three-quarters of banks believed Basel II would change the industry's competitive landscape, as large groups with the most sophisticated risk-modeling systems benefit at the expense of those who have been slower to adopt these systems.[114]

Analysis and preliminary conclusions

This chapter traced the shifts in the governance of bank capital adequacy over the course of the 1980s and 1990s and has shown the accompanying changes in the market structure. As the market structure changed, governance preferences of both private and public actors adjusted, which fed back into the policymaking process. At the same time, the new pattern of governance under the Basel I regime led to a new set of incentives in market competition that significantly changed the market structure. Below the shifts in governance along the three dimensions are discussed first, which will work towards addressing the first research question (how has the pattern of governance shifted in the policy domain). The second subsection continues by discussing the relationship between these shifts and the market structure through an analysis of the policymaking process. This addresses the second and third research questions on the characteristics of the policymaking process and the relationship of patterns of governance and changing market structures.

Shifts in governance from Basel I to Basel II

The pattern of governance for bank capital adequacy has shifted in a number of important ways across the three dimensions set out in the second chapter. The first dimension

[108] Off-the-record interview, see also www.bis.org.
[109] It must be acknowledged, however, that this sort of consultation most likely was already standard practice of banking supervisors.
[110] This interview statement is corroborated by Tarullo, 2008, p. 111.
[111] Financial Times, 15 July 2004.
[112] Financial Times, 15 November 2005.
[113] Interviews with Japanese public actors, November 2007. At the time, the policymakers ensured me that this was one of the reasons why Japan got through the crisis relatively unscathed. This situation has obviously changed significantly since then, making this claim seem somewhat like wishful thinking.
[114] Ernst & Young, 11 April 2006.

of governance distinguished concerned the jurisdictional level. On this dimension, the governance pattern as established under Basel I is a shift upwards as it brought the members of the G10 together under a harmonised capital adequacy standard. The governance of bank capital adequacy had shifted from the national to the international level. Although other countries (outside of the G10 plus the EU member states) have on occasion adopted Basel I as well, the Accord was not intended ex ante to become a global level Accord and the BCBS did not put much effort into achieving this.

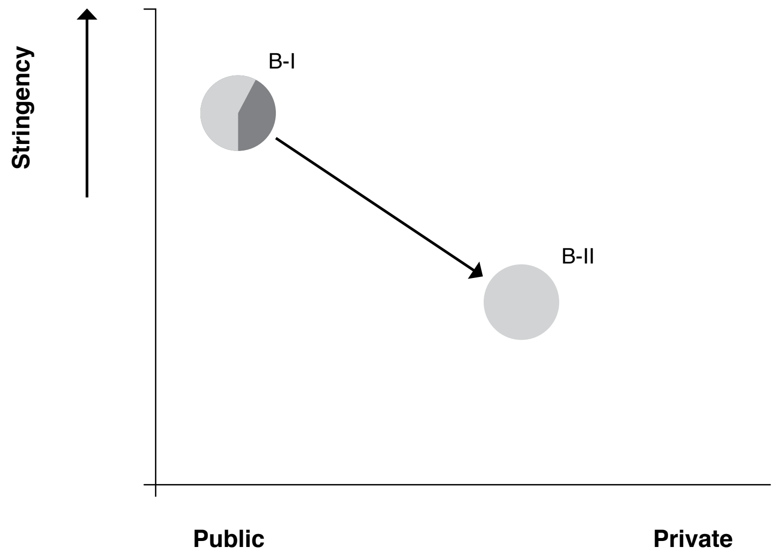
Basel II therefore signified a shift upward on the jurisdictional dimension to the global level. It formally applied in first instance to the G10 countries (and by extension to the European Union member states), but explicitly aimed to apply on the global level. Already during the negotiations many non-G10 states signalled their intention to implement Basel II. Other states were incorporated into the Basel process through the International Liasion Group. Furthermore, a special working group (the AIG) was established to aid in global implementation. Finally, the IMF was used to promote global implementation of Basel II through its FSAP surveillance. The Basel II Accord was thus clearly geared towards becoming a global level governance pattern versus the international level on which Basel I was located at the onset.

With respect to the second dimension of governance, its nature, Basel I can be characterised as a governance pattern dominated by public institutions and authority. The rules were set by public authorities, as were the calculations necessary to determine the capital adequacy ratio. The implementation was to be achieved by national level public bank supervisors with a small role for private sector self-regulation or input. Basel II shows a shift towards more private, market-based types of governance. The implementation of bank capital adequacy standards is now a mixed responsibility of private actors (which run the models) and public supervisors (which determine parameters and check the outcomes), as opposed to the public implementation of the Basel I risk-weighted capital requirements.

On the third dimension, Basel I was relatively stringent for banks (especially compared to the more informal supervision that seems to have been the norm previously). It set an 8 per cent capital charge against risk-weighted capital, which seems to be significantly higher than the level banks were subject to before the implementation of Basel I. This risk-weighted capital was calculated through five categories, hence seemingly constraining banks' flexibility in addressing risks in their balance sheets. Basel II shows a shift towards more discretion for banks under the IRB approach (and less so under the standard approach). This allows banks to use their own risk model (under certain parameters) and is consequently less constraining on their operations by more closely tying regulatory capital to actual bank activities. It also likely provided the banks applying the advanced IRB approach with a competitive advantage.

In figure 4.1 below, the relative shifts in governance from Basel I to Basel II are schematically illustrated. The vertical axis represents the stringency dimension (the further from the zero-point, the more stringent), while the horizontal axis depicts the type of governance dimension (public at the zero-point, adding more private elements the further we move away from the zero-point). The pie chart in the circles representing the Basel I and II governance pattern reflects the jurisdictional dimension: a larger lightly shaded area represents a shift upward to the global level.

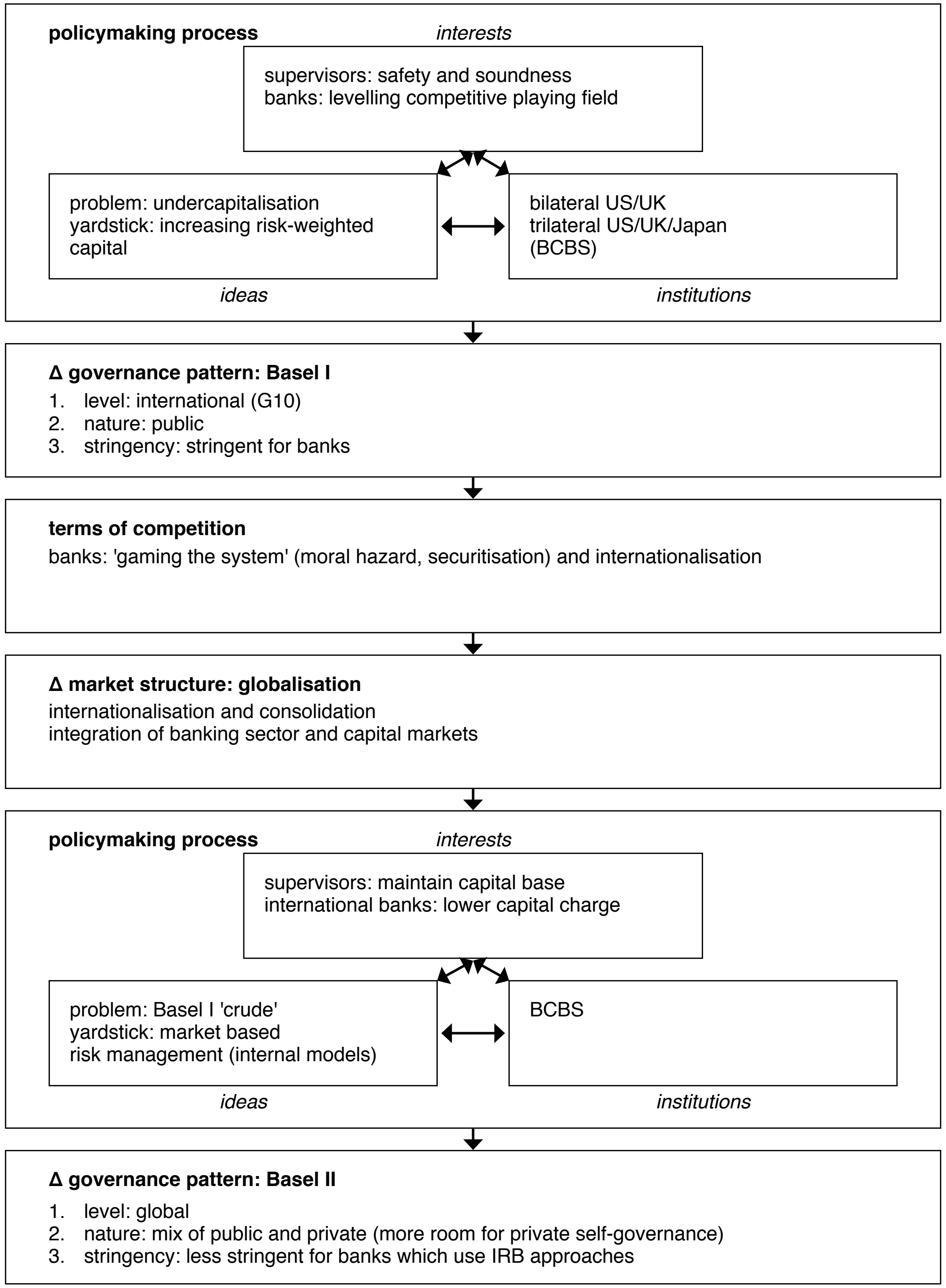
Figure 4.1. Shifting patterns of governance: Basel I to Basel II



The dynamic in the market for banking and its governance

To sum up the shifts in governance, compared to the Basel I Capital Accord, Basel II entails a shift upwards on the jurisdictional dimension, and shifts towards a more private nature and less stringent governance. In this subsection, these shifts in governance are analysed from the theoretical perspective developed in chapter 2. The following analysis is focused on the time period of this chapter and thus 'steps into' the feedback loop at the point where the first Basel Accord was being negotiated. In the concluding chapter the analysis from this chapter will be extended with that of chapter three, including the developments of the 1970s. Figure 4.2 on the next page shows the feedback loop that was introduced in the first chapter (figure 1.1) is represented in a linear fashion, making one and a half 'rounds'. Starting from the policymaking process in the 1980s (leading to Basel I) we move to the shifts in governance Basel I entailed and on to the changes in terms of competition and market structure (first full round). Subsequently the (partial) 'second round' starts with the negotiations on Basel II and ends up with the shifts in governance the Basel II pattern of governance entailed. In the following, this feedback loop will be elaborated.

Figure 4.2 Linear representation of the feedback loop between market structure and governance pattern in the case of bank capital adequacy standards



The interaction between the preference of US public actors for a stringent pattern of governance, with the preference of the US private sector to maintain or regain their international competitiveness explains why the US tried to negotiate an international level governance pattern. After failing to convince the BCBS of the need for an international agreement, the US in a sense sought to create a 'policymaking institution' in which its preferences would prevail. This succeeded in bilateral negotiations with the UK, which shared the US supervisory philosophy of risk-weighted capital requirements. This effectively set the yardstick to measure any BCBS solution against: capital requirements based on a risk-weighted capital ratio. The bilateral agreement – and inherently the threat of exclusion from the predominant global financial centres – led Japan to overcome its reluctance towards capital standards. A trilateral agreement was negotiated which saw Japan guaranteeing its banks' competitive position would not be hampered through the inclusion of unrealised equity gains in bank capital.

Only after the three main actors had reached an agreement, negotiations shifted to the policymaking institution of the BCBS, and soon after that the 1988 Basel I Capital Accord was announced. The specific combination of public preferences for a stringent pattern of governance and private preferences for international competitiveness led to two goals for Basel I: the safety and soundness of banks and levelling the international competitive playing field. The new set of incentives provided by Basel I to market actors had a significant impact on the terms of competition and subsequently the market structure. It gave banks the incentive to engage in regulatory arbitrage from off-balance sheet activities like securitisation. Furthermore, the levelling of the playing field encouraged consolidation in the banking sector and further internationalisation. At the same time, bigger banks had better abilities to 'game the system' through the complex risk management systems they developed (VaR models).

This changing market structure also had an impact on the preferences of actors. The large, internationally active banks increasingly expressed a preference for using their own internal risk models, which would lead to better risk management than under Basel I. They used influential reports by global level interest associations such as the IIF and think tanks like the G30 to develop an international consensus surrounding this more risk-sensitive approach on the policymaking agenda. Supervisors maintained their preference for a safe and sound banking system but realised banks were 'gaming the system', circumventing the safeguards of Basel I. The BCBS emerged as the policymaking institution in which these shifting preferences coalesced (for example witnessed by the landmark study into regulatory arbitrage conducted by its secretariat). This combination of shifting preferences, emerging consensus on a yardstick (market-based capital standards, i.e. the use of internal models), and a policymaking institution were the most important global level actors came together led to a renegotiation of Basel I.

The fact that the policymaking process took place in the BCBS as the policymaking institution led to the marginalisation of voices from outside the circle of expert financial policymakers, both in domestic politics (e.g. between ministries of finance/central banks and national parliaments and ministries of social affairs) and in the international policymaking process (other stakeholders than the financial sector itself). The discussions in this global policy community drew on a limited range of arguments (skewed argument pool) with a strong voice of global representatives of large internationalised banks. This is also evident from the consultative papers process that was managed by the BCBS secretariat. Although seemingly offering an open and transparent policymaking process, in fact the responses to the second and third consultative paper were heavily skewed towards private sector preferences (over 60 per cent of responses) with less than 15 per cent of responses coming from actors outside of the policy community of financial experts. Only incidentally did other stakeholders manage to assert their preferences, as we saw with Schröder's intervention on behalf of the *Mittelstand*.

The common outlook on the way forward that had emerged fairly quickly (the use of internal risk models to set capital adequacy standards), did not mean the public sector just responded to private sector demands. On the basis of the intellectual arguments for market-based approach – based on a narrow range of economic theory - the public actors set the goal of a comprehensive approach in addressing risk. In practice, this meant the public actors pushed for an operational risk capital requirement in Basel II over the opposition of private banks.

To summarise the feedback loop that is illustrated by this case study: shifting patterns of governance under Basel I changed the constraints actors faced in their actions in the global banking system, in turn leading to changing market structures. These changes in market structures also led to adaptation of preferences for governance of both public and private actors and led to a renegotiation of Basel I to Basel II. The negotiations on Basel II took place in global level policymaking institutions with a strong bias towards the preferences of large internationalised banks.

Chapter 5

Governing sovereign debt crises: From Latin America to East Asia and back

In this chapter the policymaking process concerning the management and resolution of sovereign debt crises since the 1980s is studied and related to the developments in the market structure of sovereign debt markets. By doing this, this case study sheds light on the relationship between the market structure for sovereign debts and the patterns of governance of sovereign debt crises. Ever since states discovered the benefits of using credit to finance their activities (historically mostly to wage war; more recently to finance war and welfare states) there have been occasions of over-indebtedness and the accompanying inability or unwillingness to repay creditors. These sovereign debt crises are usually accompanied by periods of major domestic economic upheaval. The cumulative decline in economic output in the three years leading to a default is 8 per cent for domestic debt default and 1.2 per cent for external debt defaults. Inflation in the year of default is 33 per cent for external debt defaults and a whopping 170 per cent for domestic debt defaults.[1] Naturally, this economic dislocation has grave social consequences. Also in the current financial crisis, several countries on the periphery of the Eurozone (e.g. Greece, Ireland) have suffered the adverse consequences of economic recession and sovereign debt problems. The governance pattern for sovereign debt crises aims to reduce these costs through an orderly and speedy resolution of these crises.

The analysis in this chapter starts with the resolution of the Latin American debt crisis of the 1980s under the Baker and Brady plans and traces the developments in this policy domain through to the debate on statutory (SDRM) and contractual (CACs) approaches in response to the series of emerging market financial crises in the second half of the 1990s. Five core arguments will be made.

First of all, it will be argued that the governance pattern emerging to resolve the Latin American debt crisis can be characterised based on the three dimensions of governance as an international level, public pattern of governance that was stringent for debtor countries and to a certain extent also stringent for private creditors. The Latin American debt crisis was resolved on an ad hoc, case-by-case basis under two successive US-led plans (the Baker and Brady plans). These plans built on the initial reaction to the crisis, which was to initiate official

[1] Reinhart & Rogoff, 2009, p. 129. Note that this data applies to actual defaults, and hence does not take into account debt crises where no default takes place.

financing through IMF programmes with attached conditionality (implying domestic adjustment), accompanied by private sector refinancing of loans. The plans applied in principle to all debtor countries in crisis, which would mean the governance pattern was 'international' on the jurisdictional dimension (not global, as the plans applied only to crisis countries, not to all countries). Although the details of the plans were left to negotiations between debtor countries and private creditors, the framework was set and monitored by public actors (predominantly the US Treasury and the IMF) under the successive plans. Lastly, the plans were stringent in the sense that the official refinancing of debtor countries included conditionality, steering debtor countries' behaviour. Private creditors were persuaded to provide limited refinancing of debtor countries (alongside the IMF financing), and hence also experienced some stringency.[2]

Second, it will be argued that the policymaking process leading to this pattern of governance was focused on US public authorities. The preferences of the US authorities reflected the market structure that had emerged over the course of the 1970s (with syndicated bank lending responsible for an increasing share of sovereign debts) and were consequently closely aligned to the preferences of their domestic financial sector. The high exposure of banks to emerging market debts, which was specifically pronounced for the US money centre banks, initially led to exclusion from consideration of governance proposals that entailed debt reductions (as these would lead to capital adequacy problems for banks). As a result, the onus was put on debtor country adjustment to solve the crisis. Only in later stages, when many private sector actors were no longer involved with the debt crisis, and actors from outside the US (notably Japan) championed solutions including debt reductions, did the window of opportunity for the Brady plan open. Throughout the process, however, discussions were focused on policymaking institutions dominated by creditor countries (such as the IMFC), and often discussions centred solely on the US. The private sector was involved through close consultation with their public authorities at the domestic level. At the international level, the private sector was mainly involved through the creditor committees negotiating with the debtor countries, while being encouraged by the public sector to establish the IIF (see also chapter three).

Third, it will be argued that the shifts in governance following the Latin American debt crisis (notably the Brady plan) led to the emergence of secondary markets and increased access to capital market financing for emerging markets. In other words, the market structure for sovereign debt changed from credit being supplied by syndicates of banks to supply by capital markets (with banks acting as intermediaries). Especially the Brady plan encouraged the growth of capital market financing of emerging markets through securitisation of sovereign debts. Moreover, on the supply side banks decided to reduce emerging market exposures (possibly also due to the first Basel Capital Accord, see the previous chapter). This significant change in market structure led to new challenges for sovereign debt crisis resolution (an increase in coordination problems, for example).

[2] Although it should be noted that private creditors reduced their exposure to crisis countries, even while co-financing IMF programmes.

This point leads to the fourth argument: that this change in market structure led to a change in preferences of major creditor states regarding the governance pattern. During the Mexican and East Asian crises of the second half of the 1990s it became clear how this new and interconnected market structure could impose serious costs on creditor states if they were to refinance debtor states. This gave creditor states the impetus to seek shifts in the governance pattern, supported by the IMF which made the intellectual case for a shift in governance in response to the changing market structure. However, with the policymaking process increasingly taking place in global policymaking institutions, the influence of international private actors increased (specifically that of the IIF). In the ensuing policymaking process, two tracks emerged: the statutory SDRM approach championed by the IMF and the contractual approach championed by the private sector and US state agencies. In addition to the contractual approach, the private sector also championed 'Principles' (originally known as a Code of Conduct) for the relations between debtor countries and private creditors.

These proposals entailed a shift in governance 'upwards' on the jurisdictional dimension, either by setting a global standard for contractual clauses, or by establishing a new global level international organisation. The nature of governance would have been public in the case of the SDRM, and to a lesser extent also in the case of the standard for CACs (although implementation depended on debtor countries and private creditors). The Code of Conduct / Principles are of a more private nature. On the third dimension, the SDRM would arguably be more stringent than the Baker and Brady plans as it could enforce a standstill and impose a negotiation framework (including majority decision-making) on debtors and all creditors. CACs restrain the actions of debtors and creditors to a certain extent, in the sense that they regulate the negotiations between debtors and creditors. They are less stringent than the SDRM and Baker/Brady governance pattern, however. The Principles are comparable to the CACs in that they stipulate rules for the negotiations between debtors and creditors, but a majority of the restrictions is imposed on the debtor states.

Fifth and finally, it is argued that the defeat of the statutory approach in favour of the contractual approach combined with the Principles can be explained by the relatively strong position of the private sector in the relevant policymaking institutions, and by an argument pool that was skewed towards market-based solutions among the participants in these policymaking institutions. Yet, at the same time the successful implementation of the contractual approach and Principles can be understood as a result of the official sector's support for the SDRM in combination with reluctant acceptance of international harmonisation by the private sector. In other words, the preferences of public actors had an important influence on the outcome.

In developing this argument, this chapter makes three contributions to the overall purpose of the thesis and to the existing literature (see also the overview of current literature in the next section). First of all, it includes the developments in the market structure for sovereign debts and its relation to the shifts in governance pattern from Brady/Baker to CACs plus

Principles into the analysis. In the current literature, the developments in the market structure are usually a black box. By opening this black box a simultaneous explanation of the developments in market structure and the (failure of, in case of the SDRM) shifts in governance patterns can be provided. This builds on the current literature in an important way. Detailing an account of the interplay between market structure and governance pattern through the policymaking process will thus be a first contribution of this chapter, corroborating the added value of the theoretical model as it was developed in the second chapter.

A second contribution follows from the first: the feedback loop from shifting patterns of governance, specifically under the Brady plan, to changing market structures in the form of capital market financing of sovereign debt shows the importance of public sector officials in the developments of both the governance pattern and market structures. In other words, particular agencies of the state have a significant influence on the developments in the global financial system, even in the face of financialisation. Furthermore, the fact that the contractual approach was successfully implemented was to a large extent due to the intellectual case for a statutory approach made by the IMF. Although the SDRM failed to overcome private sector objections, the fact that parts of the public sector pushed it as a coherent solution led to the development and implementation of CACs and Principles. While intellectually perhaps second-best solutions, these were the solutions possible given the realities of power relations between public and private actors.

A third contribution, specific to this chapter's case study, is that it shows the relationship between governance and market structures in a three-way relationship of main actors: debtor countries; creditor countries and other official sector representatives (e.g. IMF); and private creditors. Different from the governance of bank capital adequacy discussed in the previous chapter, state actors are more directly involved in the market as the demand side for credit and are in that capacity also constrained by the governance pattern (whereas in the banking case, banks are constrained and the effect on states is only indirect). The chapter therefore shows how the feedback loop between governance pattern and market structure holds in different constellations of market actors. Furthermore, this case concerns crisis resolution, whereas the governance of bank capital adequacy concerns crisis prevention. Again, this shows the breadth of the realm of policy domains to which the theoretical framework can be successfully applied.

The chapter will proceed by giving an overview of the current literature in the following (first) section. In the second section, the policymaking process concerning the resolution of the Latin American debt crisis is discussed. The third section describes how this governance pattern fed back into the market structure and changed actor preferences. This sets the stage for the next step in our feedback loop in the fourth section, an analysis of the policymaking process regarding the governance of sovereign debt crises in the wake of the Mexican and East Asian crises. The final section provides an analysis of the developments in this policy domain.

Analysing the governance of sovereign debt crises

In light of the social impact of sovereign debt crises and their regular occurrence in history, the literature examining the shifting patterns of governance in this policy domain is surprisingly meagre. The literature discussing the broader developments in the global financial system after the Latin American debt crisis is substantial, as is the literature discussing the (lack of) shifts in governance following the 1997-1998 East Asian crisis (the 'New International Financial Architecture' debate).[3] However, literature examining the specific question of governance patterns for sovereign debt restructuring is mostly restricted to specific cases or episodes. In the following overview, the focus lies on contributions to the literature that took a more encompassing approach to the developments in the policy domain of sovereign debt restructuring (i.e. case studies of specific sovereign debt restructurings are excluded). First, a number of contributions focusing on one episode of sovereign debt crises are discussed, followed by contributions that have a more extended period of analysis.

Discussing the Latin American debt crisis, Oliveri (1992) argues that the governance pattern was characterised by higher available amounts of IMF credits, limited amounts of new private financing and debt-equity conversions, and liberalisation of domestic economies.[4] His explanation of the cooperation of both public and private actors in this regime is based on self-interest. For example, banks and large debtors both had an interest in the case-by-case approach, since both expected to have more negotiating power in case-by-case negotiations.[5] This interest-based approach offers only limited insight into why the balance as represented in this regime was chosen; Oliveri focuses on explaining the participation of actors in case-by-case negotiations, rather than on the outcome of these negotiations. The bias inherent in the policymaking institutions is mostly underexplored. In other words, it offers little analytical leverage on why the shifts in governance across the different dimensions took place.

The official historian of the IMF, Boughton (2001), follows a functionalist logic to explain the central role of the IMF in the Latin American debt crisis.[6] Bankers and debtor states needed a focal point, which was provided by the IMF. As such, this can be seen as an explanation focused on institutional factors. The domestic adjustment for debtor states subsequently follows from the conditions attached to the use of different IMF facilities. Naturally, Boughton focuses on the IMF, but it can be seriously doubted whether the IMF was central in the shifting patterns of governance. The focus on the IMF seems to miss an important part of the explanation, which relates to developments in the policymaking process outside of the IMF in the form of the Baker and Brady plans (that seemingly used the IMF mainly as a tool). Moreover, Boughton

3 On the Latin American debt crisis, see, for example, Cline, 1995; Kahler, 1989; Griffith-Jones, 1989; Oliveri, 1992. For the post-Asia crisis debate see Agénor et al., 1999; Eichengreen, 1999; Robison et al., 2000; Underhill & Zhang, 2003.

4 Oliveri, 1992, p. 60.

5 Oliveri, 1992, p. 52-53.

6 Boughton, 2001, p. 177.

decidedly focuses on public actors, and gives too little attention to the role of private actors.

Strange (1998), writing at the advent of the Asian crisis, attributes a lack of change in the governance pattern for sovereign debt crises to the difficulty of coming to an international agreement on the terms and conditions of a legally enforceable system of bankruptcy.[7] This is the case especially since the 1990s as the needs of debtor countries differed widely (ranging from East Asia to the emerging post-communist states to the HIPC countries). Although Strange's account is not elaborated, it seems focused on state interests as the main explanatory factor.

Coming to the post-Asia crisis debate, Frank (2004) argues that legitimate arguments exist for – in his words – 'radical reform' (in the form of an SDRM), limited reform (like CACs) or market-based solutions; and he continues to argue that it is the reluctant stance of the US administration vis-à-vis radical reform that determines the outcome.[8] He goes on – while acknowledging that it seems an unscientific conspiracy-type explanation – to attribute this US preference to a possible fear of an independent agency determining the causes of sovereign debt crises and ending up putting the blame on the US (through spillover of US domestic policy to emerging markets).[9] He does not provide any empirical backing for this claim, however. Moreover, his explanation for the post-Asia crisis' shifts in governance is state-based and lacks a substantive account of the policymaking process.

A number of contributions to the literature combine an historical perspective covering both the Latin American and the post-East Asia crisis episodes with a specific focus on the governance of sovereign debt restructuring. Rogoff & Zettelmeyer (2002) provide an intellectual history of proposals for sovereign debt restructuring mechanisms over the last quarter of the twentieth century. Two important developments in their explanation of the emergence of different proposals are firstly a shift in the definition of the problem of sovereign debt restructuring from coordination problems between the public and private sector to coordination problems among private creditors. Secondly, the attention shifted from inefficient debt workouts to self-fulfilling debt panics.[10] This fits with the increasing role of private creditors since the 1970s, and also with the subsequent shift to capital market financing. However, they do not provide an account of the policymaking process nor provide an explanation for why no mechanism has been implemented so far (providing such an explanation is not the purpose of their paper). They show how different proposals can be derived from advances in economic theory, and are consequently focused on the factor of ideas. However, they also argue that the changes in ideas were in turn partly a result of changing market structures. In that sense, their account could be seen as focusing on market developments and ignoring the active role of state actors and shifts in governance in these market developments.

Rieffel (2003) explores the restructuring of sovereign debt both during Bretton Woods

[7] Strange, 1998, p. 100.
[8] Frank, 2004, p. 711.
[9] Frank, 2004, p. 726.
[10] Roggoff & Zettelmeyer, 2002, p. 28.

and in the post-Bretton Woods period. He provides a comprehensive descriptive account of the proposals involved, including the role of under-researched actors like the London and Paris Clubs. The account is partially informed by his own experience as a practitioner in both the US Treasury Department and the IIF. However, he does not so much explain the governance patterns that de facto emerged as he argues his case for 'ad hoc machinery' as the superior pattern of governance. For example, regarding the resolution of the Latin American debt crisis, he just remarks that the governance pattern chosen was "close to the best that was politically feasible at the time and may have been the best for advancing global welfare in the long term,"[11] without elaborating.

Soederberg (2005) argues that the informal nature of the governance pattern for sovereign debt restructuring has added to the vulnerability and volatility of the market for sovereign credit. This serves to recreate the conditions for capital accumulation by masking the power relations and exploitation practices that underlie sovereign credit.[12] It is consequently the creditor states and, more importantly, the interests of (fractions of) the capitalist class that serve to explain the current informal regime of sovereign debt crisis governance. The neo-Gramscian perspective Soederberg applies includes both state and market actors, but she points out that state actions merely serve to legitimate the underlying process of accumulation.[13]

The most comprehensive contribution to the debate comes from Helleiner, who has studied proposals for sovereign debt restructuring mechanisms from the 1930s onwards.[14] He argues that a coalition of large debtor countries and private creditors, which was in opposition to statutory sovereign debt restructuring mechanisms, managed to neutralise occasional attempts by creditor governments or international organisations to develop such a mechanism. While Helleiner provides a convincing argument as to why statutory approaches are not implemented, he does not explain why we have seen the emergence of global level market-based forms of governance like the standard for CACs and the Principles. Furthermore, he does not explicitly address the relation between governance pattern and market structure.

Finally, Lavelle (2010) compares the actors in the policymaking processes on the G77 debt workout proposals of the 1970s and the SDRM to assess the participation in and accountability of the process. She notes how the difference in market structure in the two episodes leads to the involvement of different actors in the policymaking process, but argues that a similar coalition of lenders interested in repayment and debtors interested in continued access to finance blocked proposals for formal mechanisms. While noting the developments in the 1980s (i.e. the Brady plan), the link between this pattern of governance and the subsequent change in market structure (which is subsequently reflected in wider participation in the policymaking process) is not explicitly made.

[11] Rieffel, 2003, p. 153.
[12] Soederberg, 2005, p. 928.
[13] Soederberg, 2005, p. 928.
[14] Helleiner, 2008 and 2009.

The discussion above shows how a valuable contribution can be made to the literature by extending the analyses to both market structure and governance pattern in an integrated fashion. Most studies focus on either states or markets (and hence implicitly do not overcome the dichotomous view of the two). Helleiner does not suffer from this drawback, however, and uses an approach to the policymaking process similar to the one proposed in this thesis. He thus provides an excellent base to build upon by looking at the broader debate on sovereign debt crisis resolution and not limiting the discussion to statutory approaches. The next section will start the analysis of the governance of sovereign debt restructuring by looking at the Latin American debt crisis.

The Latin American debt crisis

Onset and first response

Although the Paris Club had been a reasonably well-functioning system of public governance for official (meaning state-to-state) debt crisis resolution, as the discussion in chapter three has shown, private debts became more and more important in the 1970s. When in the summer of 1982 Mexico was the first emerging market to declare it could no longer repay its private loans, and was followed by several other (mainly Latin American) emerging markets, it became apparent that the risk exposure of banks was excessive in relation to banks' capacity to meet losses. The international syndicates of banks were involved in the emerging markets with debt problems to an extent that outstanding loans were much larger than bank capital. Table 5.1 below shows the exposures of Western banks to the HD17, a selected group of emerging markets later included in the Baker plan.[15] As the numbers demonstrate, the global banking system was at risk.[16]

Table 5.1 Exposure of Western banks to the HD17 (% of capital)

	1982	1985	1987	1992
US	130.1	86.6	63.6	26.7
US (9 largest banks)	194.2	140.1	106.6	50.6
UK	85.0	68.6	42.4	n/a
Germany	31.4	50.7	33.5	18.5
France	n/a	126.6	62.8	22.7

Source: Cline, 1995, tables 2.10 – 2.14

[15] The HD17 refers to 17 highly indebted countries identified for inclusion in the Baker plan and exemplary for the resolution of the debt crisis (see below). These countries accounted for half of total developing country debts in 1982 and were: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ivory Coast, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia (Cline, 1995, p. 39 and table 2.1).

[16] Rieffel, 2003, p. 156 provides exposure figures including all emerging markets, showing that the US banks had 186 per cent of capital outstanding in developing countries in 1982 (with the nine largest banks having almost three times their bank capital outstanding in developing countries with 288 per cent).

As the table shows, problems were biggest in the US banking sector, followed by those in France and – at a distance – the UK and Germany. The high exposure of France in 1985 can be explained by the fact that French banks were egged on by their government in the early 1980s to provide additional credit to highly indebted countries (mainly in francophone Africa) in order to support French companies.[17] Although no comparable data exists for Japan, it seems that its exposure as a percentage of capital was not high (Latin American loans only accounted for 1.4 per cent of total bank assets in 1982, compared to 7.0 per cent for the US).[18]

The Latin American debt crisis served to underscore the change in market structure that had occurred in the 1970s in the market for sovereign debt (the rise of syndicated bank lending). This also led to a significant shift in the preferences of public actors regarding the governance of sovereign debt crises. Public authorities of creditor states had an interest in putting the burden on domestic adjustment, accompanied by official refinancing as necessary, so as to keep their private financial sector solvent.[19] The private sector unsurprisingly had a preference for as much repayment as possible, and the majority of the banking community was of the view that "with appropriate interim lending programs and country adjustment effort the debt on banks' books will be shown over time to be sound."[20] Only a minority in the private sector thought debt write-offs to be necessary. An important distinction should be made, however, between the large US money centre banks and smaller, regional banks. The former were inclined to stay in the market for sovereign debts, while the latter took the crisis as a signal to get out of the sovereign debt market completely.[21]

With the increasing role of private credit, it was clear to public sector authorities that the Paris Club as a policymaking institution was not suitable for this crisis. The US public authorities took the lead in the policymaking process, coordinating ad hoc responses to the debt crisis. When Mexico first declared it would no longer be able to service its debts, it would take the IMF some weeks to arrange a rescue package. In the meantime, bridging loans were provided by the US and – egged on by the US – the BIS.[22] While the US took the lead in coordinating the parameters for the initial response to the crisis, the debtor countries were to a large extent left responsible for organising the negotiations with their creditors and the IMF within these parameters.[23]

In effect, a strategy was designed that combined domestic adjustment with official refinancing and private sector debt rollovers. In October 1982, the IMF Managing Director (Jacques de Larosière) announced at a meeting with bankers that the IMF would only provide

[17] Wiegand, 1988, p. 26-27.

[18] Stallings, 1990, p. 7 and footnote 18.

[19] Sachs claims that: "The strategy of the creditor governments therefore coalesced around one principal goal: maintaining the servicing of commercial bank claims by the debtor governments." Sachs, 1986, p. 398.

[20] Bergsten, Cline & Williamson, 1985, p. 22.

[21] Oliveri, 1992, p. 55.

[22] Kraft, 1984. Kraft provides a fascinating journalistic account of the Mexican rescue, published by the G30.

[23] Oliveri, 1992, p. 114.

emergency financing to Mexico if the private sector did so as well. In subsequent finance packages for crisis countries, the IMF continued to emphasise co-financing by the private sector.[24] This meant the approach was limiting for both the debtor countries which had to adhere to conditionality and the creditors which were forced to rollover debt. The governance pattern was therefore quite stringent.

The co-financing by the private sector did not necessarily entail a net flow to the emerging markets, however. As can be seen in table 5.1 above, banks in fact reduced their exposure over time. This is also reflected in table 5.2 below that shows the net capital flows to Latin American countries, demonstrating that in fact an outflow of capital took place. Another effect was a steadily rising proportion of official debt in the debt stock of emerging markets.[25] This was further facilitated by a quota increase for the IMF which was agreed on by the IMFC in February 1983.[26] As the G7 communiqué of June 1984 stated: "In our strategy for dealing with the debt burdens of many developing countries, a key role has been played by the International Monetary Fund (IMF), whose resources have been strengthened for the purpose."[27] The same communiqué also confirmed the G7's commitment to the case-by-case approach.

Table 5.2 Net capital flows to Latin America, 1981 – 1985 (billion US$)

Year	Net capital inflow	-	Interest repayments and foreign profits	=	Net resource transfer
1981	49.1		27.8		21.3
1982	27.6		36.8		-9.2
1983	6.1		34.9		-28.8
1984	11.6		37.1		-25.5
1985*	4.1		36.7		-32.6

* preliminary data Source: Sachs, 1986, table 1 (p. 400)

The ad hoc responses were first and foremost focused on IMF programmes as these provided both official refinancing and domestic adjustment through conditionality. Using the IMF as the primary policymaking institution provided creditor governments with significant leverage due to their high voting weights in the IMF. Given this bias in the Executive Board and the IMFC towards creditor governments, it is not surprising that the outcome reflected creditor governments' preferences. With the interests of private creditors and public authorities of creditor countries closely aligned, the protection of the solvency of Western banks seems to have informed the selected balance between official refinancing, domestic adjustment and private debt restructuring. This balance tilted towards domestic adjustment in the debtor states combined with official refinancing.

The Baker Plan

By the mid-1980s, the effects of this initial round of IMF packages began to wear off, however. A deterioration in the terms of trade for debtor countries led to new liquidity problems, which could not be easily blamed on internal profligacy or external conditions.[28] The policy adjustments in the emerging markets did not provide the desired sustained economic growth while the relatively short-term IMF loans became due. In short: the ad hoc governance pattern that emerged in the immediate wake of the crisis did not resolve it. In reaction to these developments, a team working for the new US Secretary of the Treasury James Baker III (appointed in January 1985) set out to design a more systematic programme for dealing with the crisis countries.

At the time, there was much chatter about forming a debtors' cartel to strengthen the position of the crisis countries in the policymaking process. In early 1984, Argentina had managed to get an overnight rescue from four other Latin American countries (Brazil, Colombia, Mexico and Venezuela) to prevent it from being reclassified by the US as 'in arrears'. This loan was guaranteed by the US, on the condition that Argentina agreed on an IMF programme in a matter of weeks. When Argentina failed to do this even after some extensions of the deadline, the US withdrew its guarantee in June. This made some of the prospective members of a debtors' cartel liable for the loan and hence suddenly also part of the group of creditor countries. This successfully disrupted the consolidation of a common position at a debtors' summit in Cartagena. In effect the US had effectively pre-empted formation of a unified front amongst debtor countries.[29]

This is all the more relevant since on the creditor side there was a de facto unified front. A relatively small group of creditors participated in all the case-by-case negotiations in Bank Advisory Committees (London Clubs) with the debtors, and in that way gained a strong hand in the negotiations. They could ensure no unwanted precedents were set across cases. This way of addressing the debt negotiations through the policymaking institution of the London Club consequently provided negotiation leverage for private creditors.[30]

The policymaking process developing the broader governance pattern (including the case-by-case approach to the negotiations) was mostly focused on the new team in the US Treasury. In October 1985 they had thought out their approach and Baker and Federal Reserve Chairman Paul Volcker summoned leading New York bankers to discuss their plan.[31] The private sector seemingly had to make a significant contribution: the Baker plan laid more emphasis on lengthening the maturity of debts ('private sector involvement') and renewing capital inflows

[24] Cline, 1995, p. 205-206.
[25] See figure 3.1 in chapter three. The share of official financing in the early 1970s was much higher than any time thereafter, however.
[26] The Economist, 19 February 1983.
[27] G7, 9 June 1984.

[28] Sachs, 1986, p. 401.
[29] Oliveri, 1992, p. 173 – 174.
[30] Garay, 2010, p. 117-118.
[31] The Economist, 5 October 1985.

(amongst other means by a greater involvement of the World Bank and regional MDBs). The Baker plan encouraged banks to issue new loans to debtor countries to the tune of US$ 20 billion of increased exposure over three years. This would be accompanied by US$ 9 billion of new multilateral financing (including, of course, conditionality).

The debtor countries would be pushed into further reform in three areas: removing import barriers, removing restrictions on foreign investment and privatising loss-making state enterprises. The conditionality associated with these latter areas was at the time not part of the standard IMF conditionality.[32] This meant that debtor countries had to implement new, market-oriented structural reforms aimed at forcing debtor countries to conform to the policy agenda set by US public authorities coalescing with financial market actors. Although the Baker plan seemed to put the burden of refinancing on the private sector, it should once again be noted that in the period of the Baker plan banks continued to reduce their exposure and there was consequently no net inflow of private capital (see table 5.2 above). As Sachs puts it "the methods of the Baker plan were merely an intensification of earlier procedures."[33]

A week after his meeting with the private bankers, Baker outlined his 'Program for Sustained Growth' at the 1985 IMF Annual Meeting in Seoul. The Interim Committee's communiqué did not explicitly endorse the Baker plan, but did point out that to solve the crisis effective adjustment in debtor countries was necessary as well as appropriate flows of official and commercial finance. The communiqué also reaffirmed the central role of the IMF in the governance of the Latin American debt crisis.[34]

After a lukewarm reception by the private banks, the Managing Director of the IMF and the President of the World Bank put their weight behind the plan by issuing a joint statement on 2 December 1985 proclaiming their strong support.[35] Also, the governors of the G10 central banks came out in favour of the Baker plan. In response to that, banking groups from various countries indicated their support. The US banks sent a letter to the Secretary of the Treasury and heads of the IMF and World Bank dated 11 December declaring their support, "provided that all other parties, governmental, institutional and banking do the same."[36] The UK banks in a letter dated one day later also expressed their "willingness to play their part on a case-by-case basis," making the same provision as the US banks.[37] German banks followed on 21 January, emphasising the importance of conditionality but also creditor government policy to improve the debt repayment capacities of debtor states (e.g. creating more favourable conditions for trade).[38] Wiegand concludes that given the similarity in the statements of support (all including the caveat that all relevant parties should also play their part), coordination

[32] Oliveri, 1992, p. 64 mentions these items next to IMF conditionality.
[33] Sachs, 1986, p. 401.
[34] IMFC, 7 October 1985.
[35] IMF Archives, 27 November 1985.
[36] IMF Archives, 23 December 1985a.
[37] IMF Archives, 23 December 1985b.
[38] IMF Archives, 22 January 1986.

between international banking groups had taken place. At the same time, he notes that continental European banks were more muted in their support because they did not agree to the new financing commitments under the Baker plan.[39]

The US-designed Baker plan was clearly the central plank of the debt crisis governance pattern. At their first meeting after the Seoul Annual Meetings (May 1986), the communiqué of the G7 heads of state read:

> *We reaffirm the continued importance of the case-by-case approach to international debt problems. We welcome the progress made in developing the cooperative debt strategy, in particular building on the United States initiative. The role of the international financial institutions, including the multilateral development banks, will continue to be central (…) Sound adjustment programs will also need resumed commercial bank lending, flexibility in rescheduling debt and appropriate access to export credits.*[40]

The Baker plan did not entail significant shifts in governance over the earlier ad hoc responses, as it was quite similar to those responses. It was more a formal expression of a shift upwards to the international level that had already taken place. It extended the conditionality to a certain extent (making it more stringent for debtor countries) and talked about more extensive debt restructuring, without adding much additional stringency for private banks than they were already facing. The collective action problems in the Latin American debt crisis were thus in first instance solved by ad hoc coordination between creditors and, most importantly, the IMF imposing (limited) burden sharing. This did not include debt reduction yet, putting the highest burden on the debtor countries. During the period of the Baker plan, the first effects of the new governance pattern on the market structure became visible, however, which is the subject of the next section.

Banks reshaping their market position in response to the Baker plan

A first change in the market structure in response to the shifts in governance the Baker plan entailed was the emergence of a secondary market for sovereign debts. Banks got rid of their existing exposure through debt swaps, and once rid of their exposure were no longer forced to participate in the co-financing of IMF programmes. As early as in 1985, the value of this market was put between US$ 2.5 and 3.5 billion.[41] Discounts in the secondary market were significant, as table 5.3 on the next page shows. This reflects that market participants did not expect a full repayment of debts.

[39] Wiegand, 1988, p. 36.
[40] G7, 6 May 1986, para. 10.
[41] The Economist, 12 April 1986.

Table 5.3 Secondary market prices for selected debtor countries (% of face value)

	July 1985	Jan 1986	Jan 1987	Oct 1987
Argentina	60-65	62-66	62-65	34-38
Brazil	75-81	75-81	74-77	35-40
Chile	65-69	65-69	65-68	52-56
Peru	45-50	25-30	16-19	2-7
Poland	55-60	50-53	41-44	41-43
Romania	85-89	91-94	86-89	86-89
Yugoslavia	74-77	78-81	77-81	57-62

Source: Anayiotos & De Piniés, 1990, table 1 (p. 1660)

With the passing of the initial shock of the crisis and the start of the Baker plan, a second change lay in the fact that divisions within the banking community increasingly began to show. Inter-firm competition with respect to the preferred debt crisis strategy increased. At the time, the IIF did play some part in the international coordination of the private banks' position vis-à-vis the resolution of the debt crisis, but was not yet involved in advocating a coherent alternative policy at the international level (see also chapter three).

Although American banks provided on average 35 per cent of private loans to Latin American debtors, their representation on the creditor steering committees of the six major creditors ranged from 45 to 58 per cent. According to interviews with creditor committee participants done by Stallings, the American banks played the leading role in decision-making.[42] This dominant position of leading US banks did not sit well with their competitors. Furthermore, within the US, the big US money centre banks (which had the highest exposure) had a strategic interest in continued business with emerging markets, while smaller, mainly domestic US banks wanted to get out of the business completely (which they were able to do through the secondary markets).

Differences in tax and capital reserve policies between American, European and Japanese financial regulators led European and Japanese banks to be increasingly resistant to new lending. European banks were more inclined to capitalise interest payments coming due rather than provide new money.[43] Banks in continental Europe had already gradually built up reserves during the crisis, for various reasons (tax-deductibility, accounting and reporting standards, and a reduced emphasis on shareholder value concerns). Thus continental banks were only lukewarm supporters of the US-UK stance.[44] For example, around the October 1987 IMF Annual Meeting, Germany's biggest bank suggested it might consider forgiving a large part of Brazil's debt and get out of the debt talks altogether.[45]

[42] Stallings, 1990, p. 12.
[43] Wiegand, 1988, p. 9.
[44] Wiegand, 1988, p. 15 and 20/21.
[45] The Economist, 3 October 1987.

As pointed out above, the exposure of banks to debtor countries was slowly reduced due to net capital outflows from the countries. In addition to this, in May 1987 Citibank set aside some US$ 3 billion in loan loss reserves against the Latin American loans (25 per cent of its exposure). In first instance this astonished their colleagues, but soon other US and British banks followed the Citibank example. Over the course of 1987-1988 provisioning rose to about 50 per cent of outstanding developing country exposures.[46] Although partially aimed at showing the banks were prepared for a fight with the more assertive debtor countries (see below), it also sent the message that banks no longer valued the sovereign debts at full value (consequently driving down secondary market prices, see table 5.3 above). This move undercut the position of major US and UK banks that any restructuring should not lead to losses for banks and that the IMF-led case-by-case approach would be enough to restore creditworthiness. It also gave the banks more freedom to choose their strategic direction, no longer being held hostage by the sovereign debt crisis.

At the same time, the demand side in the form of debtor countries became more assertive. With the dangers to the (especially American) banking sector slowly diminishing, attention of the US government for the implementation and successful conclusion of the Baker plan diminished. This led debtor governments to take a more proactive stance.[47] Peru had already unilaterally declared its intention to limit debt servicing to 10 per cent of export receipts (which also explains its dismal secondary market value in table 5.3). Powerful opposition groups in several of the main debtor countries were pressing for similar initiatives from their home governments.[48] This culminated in Brazil declaring a moratorium on interest payments at the beginning of 1987.

Debtor governments also took the initiative by finding 'innovative' approaches to debt restructuring and new demand for credit. This included, for example, more capital market-based financing, and served as 'experiments' to restructure the market in ways both the demand side (debtor nations) and supply side (private creditors) could live with.[49] Banks increasingly made the strategic choice to act as intermediaries in sovereign debt, rather than as end holders.[50] This changed their terms of competition, as they were, for example, no longer competing with other sources of funding. The newly emerging capital market for sovereign debts also offered opportunities for primary debt sourcing.

In short, one of the effects of the Baker plan was that it facilitated a shift in the preferences of private banks regarding the resolution of the debt crisis. As banks reoriented their market position through the development of capital market financing of sovereign debts, their preferences lay less with full repayment of outstanding debts. The discount on the secondary

[46] Rieffel, 2003, p. 165.
[47] Shepherd, 1994.
[48] Sachs, 1986, p. 403.
[49] Rieffel, 2003, p. 165-166 points to innovative financing deals by Mexico and Brazil.
[50] De Carmoy, 1987, p. 15. It turned out that this was a rather profitable business, see table 4.3 in the chapter on the governance of bank capital adequacy.

market in a way reflected the market acceptance of debt reductions. On the official side, creditor governments lost the sense of urgency due to the reduction of the risk of a financial system collapse. Debtor countries as the third party in this balancing act took a more assertive stance and started pushing for 'innovative' approaches to debt restructuring through more capital market-based financing.

Completing the resolution of the Latin American debt crisis: the Brady plan

As elaborated above, changes in the market structure led to shifting preferences of public and private policymakers. When these shifting preferences fed back into the policymaking process, a window of opportunity opened for new directions in the crisis resolution process, notably proposals entailing debt reduction. The manoeuvring by the commercial banks, but more importantly the struggle of public debtor and creditor state actors, was the prelude to the third and final phase in the resolution of the Latin American debt crisis: the Brady plan.

The possibility of debt reduction had already been advocated since the early 1980s by many academics, most notably and vocally professor Sachs of Harvard University and professor Kenen at Princeton.[51] This gained some traction in the policymaking process when in an August 1986 speech Senator Bill Bradley (New Jersey, not to be confused with Secretary of the Treasury Brady) proposed to maintain the case-by-case approach but include an 18 per cent debt reduction over three years, to be tied to trade liberalisation under the GATT.[52] This was the first time the possibility of debt reduction was taken up by a significant American policymaker. It offered few details or further innovations over the earlier approach, however.

Kenen had suggested setting up an 'International Debt Discount Corporation' (IDDC) that would buy debt at a discount and convert it to longer maturities.[53] This would mean a public-type governance pattern at the global level, ready for future sovereign debt crises. As the IDDC would benefit from official backing, it could be seen as an alternative way to provide official financing, with the most important difference over the market-based alternative being that the private sector would be taken out of the debt crisis resolution negotiations (as they would sell their debts to the IDDC, which would subsequently negotiate restructuring terms and conditionality with the debtor country).

The Kenen proposal was endorsed by two Democrat members of the House of Representatives (Morrison and LaFalce). They proposed an IDDC under the umbrella of the World Bank and managed, together with Representative Schumer (D), to put a clause in an omnibus trade bill in 1987 that instructed the Secretary of the Treasury to initiate international negotiations with the aim to establish what they called an International Debt Management Authority.[54] An important caveat in the clause, however, provided that the Secretary could refrain from such negotiations if the Secretary judged they would negatively affect the current or future value of sovereign claims.[55] A variant of the plan was also endorsed by William Seidman, chairman of the FDIC in July 1989.[56]

As mentioned above, continental European banks had increasingly different preferences from their American counterparts. However, the US Treasury and IMF exerted pressure on the home governments of continental banks to continue to follow the US line. This was reinforced by the linkages of continental European banks to large US banks, providing another avenue of influence.[57] The Japanese banking sector, on the other hand, was led by the Bank of Tokyo which was the single largest international operator. Its preferences were closely aligned with the American banks and they supported the Baker Plan (they were even more cooperative than the American banks themselves, according to Stallings). However, the only domestic rival to the privileged position of the Bank of Tokyo, the Industrial Bank of Japan, publicly supported the Bradley plan.[58]

Japan started playing a more assertive role in the debt crisis debate, and developed its own plan (the Miyazawa plan), which laid the foundations for the Brady plan. The Miyazawa plan aimed to securitise part of the troubled debts against a lower interest rate and with collateral provided by official reserves of the debtor countries to be deposited at the IMF. Interestingly, the new Treasury Secretary Nicholas Brady attacked the plan when it was publicly proposed by Japan at the September 1988 IMF Annual Meeting in (West) Berlin.[59] However, the IMFC communiqué did endorse the possibility of debt reduction, and stated that the menu of options should be broadened to include "voluntary market-based techniques which increase financial flows and reduce the stock of debt without transferring risk from private lenders to official creditors."[60]

With the secondary market value of emerging market debts decreasing and the debtor countries increasingly assertive, the preferences of all the main actors had begun to shift in favour of debt reductions. In response to this, Brady developed a new comprehensive plan. Most of the intellectual work had already been done in the Treasury under the previous Reagan administration,[61] as well as by the Japanese. Given its origins in the Reagan administration it should not come as a surprise that market-based solutions were preferred over more public interventions like Kenen's IDDC proposal. This was in line with the neoliberal ideological conviction of Reagan's administration, as well as with bankers' interests.

[51] Rieffel, 2003, p. 169.
[52] See Cline, 1995, p. 216.
[53] See, for example, Kenen, 6 March 1983 for his proposal.
[54] Noteworthy, LaFalce and Schumer represented New York state constituencies, although not New York City.
[55] Cline, 1995, p. 226.
[56] Kenen, 1990, p. 15 (footnote 9).
[57] De Carmoy, 1987.
[58] Stallings, 1990, p. 19-20.
[59] Stallings, 1990, p. 25.
[60] IMFC, 26 September 1988.
[61] Rieffel, 2003, p. 168.

US Secretary of the Treasury Brady announced his plan during a speech at the Brookings Institution on 10 March 1989, and with this plan he swept aside the proposals of a more public nature coming from the House of Representatives (the aforementioned International Debt Management Authority) and ignored governmental voices from continental Europe that were in favour of those kinds of solutions as well. Different from the Miyazawa plan, the Brady Plan had a broader 'menu of options', for example, the discounting of loans when they were securitised. It basically built on the experience gained during the Mexican rescheduling of 1988.[62] As mentioned above, this Mexican package reflected innovation in the demand side of the market.

The Brady plan shifted the balance from domestic adjustment to debt forgiveness by the private sector and increasing official financing. However, the debt forgiveness under the Brady plan was premised on a voluntary, market-oriented approach to debt reduction:

> *Commercial banks need to work with debtor nations to provide a broader range of alternatives for financial support, including greater efforts to achieve both debt and debt service reduction and to provide new lending. The approach to this problem must be realistic. The path towards greater creditworthiness and a return to the markets for many debtor countries needs to involve debt reduction.*[63]

The Brady plan also suggested using funding by the IMF and MDBs to collateralise new bonds, which would include private sector debt reduction. Brady furthermore opened the door for official lending to countries in arrears even without concrete commitments from private creditors. This prevented the private sector from keeping official refinancing 'hostage' by refusing to co-finance. In concluding the speech in which he set out his plan, Brady re-emphasised the objective "to provide maximum opportunities for voluntary, market-based transactions rather than mandatory centralization of debt restructurings."[64]

Charles Dallara, the US Executive Director (ED) at the IMF (and later head of the IIF), presented the plan to the Board. He pointed out that debtor countries could use funds for direct buy-backs of loans, but that the US authorities thought securitisation was a better approach (hence providing a spur to sovereign debt markets). He furthermore emphasised that his authorities thought conditionality on foreign direct investment (in other words capital account liberalisation) was very important. The Japanese ED expressed the 'strong support' of his authorities for the Brady plan.[65]

Next to its central role in the different Brady programmes for debtor countries, the IMF proceeded to develop the 'Lending into Arrears' (LiA) policy. The experience up to date had led private creditors to conclude that being reluctant in good faith negotiations with debtors would also limit IMF funding, and hence would spell trouble for debtor countries.[66] The LiA policy addressed this brinkmanship and was one of the few enduring elements of the governance pattern addressing the Latin American debt crisis. Debtor nations could now obtain IMF refinancing while being in arrears to private creditors (which was not possible earlier). This increased debtor state (and IMF) leverage vis-à-vis private creditors. The LiA policy was agreed on in 1989 and was to provide Fund support to countries in arrears on a case-by-case basis provided that (1) Fund support was deemed essential for the successful implementation of the debtor country's adjustment programme and (2) negotiations between debtor country and creditors had started.[67]

After considerable pressure by the US Treasury on private banks, the first Brady deal was concluded with Mexico in July 1989, including a 35 per cent haircut (midpoint between the initial Mexican position of 55 per cent and the private sector's offer of 15 per cent). By May 1994, deals had been completed with or announced for 18 countries, heavily overlapping with the HD17. In the end, 17 countries actually concluded Brady deals between 1990 and 1997 with US$ 210 billion of commercial bank debt reduced by about US$ 85 billion (an average haircut of 40 per cent).[68] The Latin American debt crisis could be considered as resolved, as far as policymakers were concerned.

As the evidence from this episode shows, the governance pattern emerging in the wake of the Latin American debt crisis was an international level, public pattern of governance. However, it clearly diverged from the previous Paris Club workouts as it also included important channels of private sector influence. The Latin American debt crisis was resolved on an ad hoc, case-by-case basis under two successive US-led plans (the Baker and Brady plans). The policymaking process consequently focused on the US and to a lesser extent on the IMFC as policymaking institutions. Although the details of the plans were left to negotiations between debtor countries and private creditors, the framework was set and monitored by public actors (predominantly the US Treasury and the IMF) under the successive plans, restraining the actions of both debtor countries and private creditors.

The close alignment of official US preferences to the preferences of their internationally active banks led to plans that put the burden of adjustment primarily on debtor countries, accompanied by official refinancing (and limited private refinancing). Although there were mutterings of a debt cartel, debtor countries were too preoccupied with their domestic troubles to collectively advocate their preferred solutions in the relevant policymaking institutions. This strengthened the hand of private creditors in the negotiations, and can also serve as part of the explanation why the burden came to lie on domestic adjustment in resolving the crisis.

62 The Economist, 6 February 1988.
63 Department of the Treasury, 10 March 1989, p. 5.
64 Department of the Treasury, 10 March 1989, p. 8.
65 IMF Archives, 15 March 1989.
66 Diaz-Cassou, Erce-Dominguez & Vazquez-Zamora, 2008.
67 Boughton, 2001, p. 535.
68 Rieffel, 2003, p. 151.

Only belatedly, when domestic adjustment did not deliver enough results in terms of economic growth and the private sector had had time to adjust to the new reality by changing the market structure, did debt reduction become an option. This was to a large extent linked to the advent of the secondary market and the business decisions of banks to shift from the sovereign lending business and set up loan loss reserves. This changed the market structure, and hence the preferences regarding the governance pattern. The ensuing policymaking process resulted in the Brady plan, which reinforced these trends in the market structure (as will be discussed in the next section).

The close involvement of the private sector in the debt restructuring negotiations furthermore led to the emergence of an international policy community where internationally active banks were involved in the policymaking process, mainly through their domestic authorities and limited coordination amongst themselves. The private sector was egged on in this respect by public authorities to come to a global interest representation in the form of the Institute of International Finance.

At the same time, especially the Brady plan did lead to limited new global level, public-type governance in the form of the LiA policy and enhanced IMF conditionality. These elements of the governance pattern emerging in the wake of the Latin American debt crisis also endured after that crisis was resolved. This consequently entailed a shift in the stringency dimension, mostly for the debtor countries that could now be faced with more intrusive conditionality. This conditionality was in line with what later became known as the Washington Consensus of market-based reforms, which was emerging as the yardstick to measure economic programmes against.[69] In the next section, the impact of this governance pattern as formulated under the Brady plan on the market structure is discussed.

Bonding together: the Brady bonds and capital market financing

As figure 3.1 in chapter three has shown, bond financing of emerging markets increased significantly over the course of the 1990s. Brady bonds played an important role in this take-off, as early in the decade they accounted for over half of trading volume.[70] Table 5.4 below lists bond issues by emerging markets in the first half of the 1990s, showing how these steadily became a more important part of international bond market (although still small compared to developed country international bonds, at 12.6 per cent of the total market in 1994). Furthermore, the table shows how the private sector found their way to the global capital markets in the slipstream of public actors: the private sector share in international bond issues of developing countries steadily increased. Many private sector bond issues came from the financial sector, which is especially prone to implicit government guarantees (in other words, private credits might quickly convert into a sovereign debt crisis).

Table 5.4 International bond issues by developing countries (million US$)

	1991	1992	1993	1994	1995 (first half)
Sovereign	4,487	5,658	16,441	12,676	4,789
Public sector	4,419	7,256	16,906	13,078	3,787
Private sector	5,125	11,480	29,323	32,635	9,197
total	14,031	24,394	62,671	58,383	17,774
% of total international bond issues	4.5	7.0	12.5	12.6	7.5

IMF Archives, 14 August 1995, table 6 and 7

The impact of the Brady plan on the global financial system led the trade journal LatinFinance to include Brady in their top 40 of most important persons in Latin American finance of the twentieth century, noting that: "If anyone is entitled to take personal credit for the creation of the emerging market asset class, it is Nicholas Brady."[71] In other words, the pattern of governance under the Brady plan provided an enormous boost to the secondary market in emerging market sovereign debt, as well as jump-started a primary market for these debts.

This diversification of the creditor base of states, however, could complicate the coordination between creditors in a possible sovereign debt crisis. This was already acknowledged by the IMF in the mid-1990s,[72] and led to preliminary shifts in their preferences regarding the governance of sovereign debt crises. The case for adjusting the governance pattern was brought home by the December 1994 Mexican crisis. This was only the first in a series of emerging market crises, which underscored that the capital market-based global financial system was also more crisis-prone.[73]

Under a fixed exchange rate regime, Mexico received large capital inflows in the beginning of the 1990s. When the sentiment of traders on the global capital markets changed due to domestic political turmoil and an unfavourable external macroeconomic environment, capital flight occurred. After an initial attempt to defend its peg, Mexico was forced to abandon its fixed exchange rate regime, in the meantime having incurred an unbearable level of external debt. As this financial crisis originated in the capital markets (and not so much in bank credits), it was dubbed the 'first financial crisis of the twenty-first century.'

[69] See also chapter three for a discussion of the role of the Washington Consensus in the 1970s and 1980s.
[70] IMF Archives, 14 August 1995, p. 16. Brady bonds accounted for 61 per cent of trading in 1994.

[71] LatinFinance, July 2003, p. 31.
[72] IMF Archives, 14 August 1995, p. 93.
[73] See also Bordo et al., 2001.

Shortly after the Mexican crisis had already hinted at the potential volatility of global capital markets, the 1997-1998 East Asian crisis shook the global financial system to its core by dipping an entire region in economic crisis and spreading all over the world (notably to Russia and Brazil) through 'contagion' on the capital markets. The East Asian crisis underscored the drawbacks of the 1990s capital market-based market structure that had already been brought to light by the Mexican crisis. In several cases, the quick withdrawal of private creditors led to sovereign debt problems or banking crises (which subsequently turned to sovereign debt crises as states tried to rescue their domestic banking system). Although moral suasion of banks could still work (notably in the case of Thailand), in other cases it was clear capital market financing brought new problems of creditor coordination, contagion and herd behaviour.[74]

The East Asian crisis led to a wide-ranging debate on a new 'international financial architecture'.[75] This debate concerned both crisis prevention and crisis resolution. The policymaking process in crisis prevention mainly focused on improving market efficiency through more transparency (leading to a variety of international standards aimed at increasing public actors' data disclosure[76]) or on bolstering countries against 'irrational' financial markets (e.g. by making the IMF a lender of last resort or by capital controls). The governance of sovereign debt crises was the most important plank of the debate on crisis resolution, with strengthening the effectiveness of IMF conditionality as a second track.

In this whirlwind of proposals, the common pro-market outlook of the policy community rapidly precluded some ideas, such as capital controls or a Tobin tax.[77] It also led to a strong emphasis on transparency as a way to improve the functioning of markets, with less attention to other planks of reform (e.g. regarding Private Sector Involvement, PSI). The new 'international financial architecture' turned out to be a pattern of governance based on market discipline. Proposals were measured against the yardstick of improving market efficiency. The specific proposals on the governance of sovereign debt crises are discussed in the following section.

Global turmoil and the redesign of the 'International Financial Architecture'

Due to the changes in market structure in the form of capital market financing of states, important realignments of preferences had taken place particularly among public officials in creditor states. Fear of moral hazard and 'bailing out the private creditors,' combined with the sheer magnitude of capital market finance (and hence the official refinancing needed) shifted their preferences towards new patterns of governance. As mentioned above, the Mexican debt crisis brought the implications of the new market structure for the governance of sovereign debt crises to the fore. The dispersed, anonymous bond holders had to be included in the balance between official refinancing, domestic adjustment and private rescheduling somehow, lest the burden fall on debtor countries and official refinancing only – a burden the official financiers were unwilling to bear. However, also the policymaking process had changed: the main policymaking institutions now operated at the global level and had close ties to the private sector, as will be further discussed in this section.

Governance in the wake of Mexico – preliminary considerations

The initiative was seized by the G7 in the aftermath of the Mexican crisis, underscoring its role as an apex forum (the prime policymaking institution).[78] The G7 heads of state at their summit in Halifax (June 1995) commissioned the G10 to draft a report on the orderly resolution of crises: "recognizing the complex legal and other issues posed in debt crisis situations by the wide variety of sources of international finance involved, we would encourage further review by G-10 Ministers and Governors of other procedures that might also usefully be considered for their orderly resolution."[79] This meant that the possible shifts in governance in response to the crisis were to be discussed in a policymaking institution solely composed of public authorities of creditor states.

Notwithstanding this referral of the matter from the G7 to the G10, a shift in preferences had also taken place in the IMF bureaucracy as it realised its resources could not deal with these new capital market-induced crises. Only three weeks before the Halifax summit, it had issued a note on an 'International Debt Adjustment Facility for Sovereign Debtors' to the Executive Board.[80] The note, prepared by the legal department, mentions three issues that would have to be resolved for such a facility to work: (1) whether it should only cover sovereign debts, or also other public or even private liabilities; (2) how the facility would be 'triggered'; and (3) whether it should be part of the IMF or become a separate entity (and how it would relate to the IMF as creditor). The note was cautious in not actually proposing a mechanism, but just to point out that states and creditors might in some case prefer to turn to such a mechanism.[81] This was reiterated at the Executive Board meeting: the note was only a feasibility study and not intended to make a proposal or discuss the 'political, economic and philosophical issues involved.'[82]

The actual Executive Board meeting took place on 23 June, a week after the Halifax Summit, and somewhat dismayed some EDs representing G10 states. Schoenberg (Germany)

[74] See Blustein, 2003 for a gripping journalistic account of the East Asian crisis and the moral suasion in the Thai case.
[75] See for an overview Eichengreen, 1999.
[76] See Walter, 2008 for the results of these efforts.
[77] Cohen, 2003.
[78] See Baker, 2006 for a discussion of the G7 as apex policy forum.
[79] G7, 16 June 1995.
[80] IMF Archives, 26 May 1995 and 23 June 1995.
[81] IMF Archives, 26 May 1995, p. 4.
[82] IMF Archives, 23 June 1995, p. 3.

rather curtly noted the G10 had already committed significant resources to their G7 assignment, and that it "might have been useful to await the publication of this report before entering into another discussion in the fund."[83] Autheman (France) was rather candid: "One of the reasons why I prefer the discussion continue in the BIS forum [the G10] rather than in this forum is that we have a major interest at stake; and we should sometimes behave in a self-serving way."[84] However, most EDs of G10 countries, including most importantly Lissaker (US), encouraged the IMF to further develop their proposals in tandem with the G10. EDs Kaeser (Switzerland), Wei (China) and Tulin (Russia) already spoke out strongly in favour of the Facility, while most other EDs remained reserved. The general sentiment was that the legal department had 'jumped the gun' and that the political and economic issues had to be dealt with before establishing the feasibility of the Facility. The IMF staff had been given its homework.

In the meantime, the working group of the G10, headed by Jean-Jacques Rey (Executive Director of the National Bank of Belgium), proceeded with their work. An important part of this work consisted of consultations with private creditors, amongst others requesting the input of the private sector through two questionnaires executed by G10 member states' authorities. In their responses, most private creditors indicated that rules for sovereign debt resolution would increase moral hazard of debtor countries, and consequently in a situation of proactive market response lead to higher risk premiums (only a few conceded that an orderly resolution mechanism might reduce risks).[85] Furthermore, creditors pointed out that CACs would be an infringement of their rights. Interestingly, the IMF as the primary source of official refinancing was viewed with suspicion because it would favour debtor states (especially those with good ties to large IMF shareholders).[86] The idea of an international bankruptcy court was "almost unanimously rejected by the market participants as not being feasible and maybe even counterproductive. (…) They were also concerned that such a court might be inappropriately biased towards the debtors compared with present arrangements."[87]

In their May 1996 report (the Rey report) the G10 most significantly advocated adding collective action clauses (CACs) in international bond contracts. A second prominent recommendation was to revise the LiA policy of the IMF to include bond debts. In other words, the IMF would also be allowed to lend to debtor states in arrears on their bonds. Furthermore, the report reiterated the responsibility of debtors for 'sound economic policies' and a preference for a case-by-case approach.[88] The Rey report did not set an explicit global level standard, but was only a recommendation for market actors to implement CACs. In that sense, is seems hardly justified to interpret the Rey report as entailing shifts in governance in any significant way.

[83] IMF Archives, 23 June 1995, p. 4.
[84] IMF Archives, 23 June 1995, p. 50.
[85] G10, May 1996, p. 30-31.
[86] G10, May 1996, p. 34.
[87] G10, May 1996, p. 36.
[88] G10, May 1996.

Given the strong private sector input, it is not surprising that the creditor state authorities decided to opt for a market-based approach (a contractual approach). The report explicitly emphasised that "international bankruptcy procedures and other formal arrangements do not appear to provide, in current circumstances or in the foreseeable future, a feasible or appropriate way of dealing with sovereign liquidity crises."[89] It seems that the IMF staff heeded this explicit rejection of statutory approaches by its largest shareholders well, as the 'homework' of the Executive Board meeting on the Facility seems never to have been finished and discussed with the Board in this period.

The suggestion of CACs already went against the grain of many private creditors (as the responses above made clear), but at least signified progress for public authorities not willing to stump up ever larger amounts of official refinancing. CACs are a market-based solution, also in the sense that they require negotiations between the debtor state and private creditors as market actors. They do entail a small shift in power towards debtor countries (through the majority provisions), but at the same time force debtor countries to engage in constructive negotiations. CACs could be seen as a more stringent governance pattern, as they bind both debtor countries and private market actors to pre-established rules regarding the negotiations in case of a sovereign debt crisis. CACs were thought to be a 'practical' (achievable) solution, also because they were already market standard in the international bond market of London.

The Rey report met with quite a few negative reactions of market actors and received only lukewarm support from most debtor countries.[90] The possible shifts in governance through the implementation of CACs, as envisaged in the Rey report, did consequently not materialise. The Rey Report was duly ignored by the private sector and bond-issuing countries. This was also due to the discussion on the governance of sovereign debt crises being overtaken by current events at that time: the 1997-1998 East Asian crisis.

The immediate response to the East Asian crisis was quite similar to the response to the Latin American debt crisis: IMF-led financing combined with moral suasion of banks to rollover loans (most notably in the South Korean case). However, the sheer magnitude and domestic costs of this crisis brought global financial governance under increased public scrutiny. The scale of official refinancing necessary for resolving the East Asian crisis once again underscored that creditor state authorities were in danger of having to put up large amounts of taxpayers' money in case of large-scale crises. This gave a new impetus to discussions on the governance of sovereign debt restructuring. Public authorities in creditor states once again felt they had to bear too much of the burden. Economists pointed to the 'moral hazard' created by the IMF bailouts, encouraging the private sector to engage in risky lending practices and heightening the chances of sovereign debt crises.[91] In first instance, this led to a debate on 'Private Sector Involvement'.

[89] G10, May 1996, p. 5.
[90] National Bank of Belgium, 2002, p. 113.
[91] See, for example, Haldane & Scheibe, 2004.

Elusive Private Sector Involvement

A first concrete result of the debate on PSI was a follow-up on the recommendation of the Rey report concerning the Fund's Lending into Arrears policy. Although the IMF management was wary of extending the LiA policy to bond debts out of concerns for litigation by bond holders, pressure from several EDs (representing continental European G10 members) led to a proposal discussed by the Executive Board in February 1998.[92] It was decided to incorporate bonds under the LiA policy, meaning the Fund could provide official refinancing to debtor countries in arrears on their bonds. As an additional condition next to the two in the original LiA policy, debtor countries were now not only required to have started negotiations to resolve the arrears, but also to negotiate 'in good faith' with private creditors.[93] As with the establishment of the LiA policy during the Latin American crisis, this prevented bond holders from keeping IMF negotiations hostage and reflected the new market structure dominated by capital market financing of emerging markets.

In the further debate on PSI, however, it turned out to be an elusive term. It meant the possibility of forced debt reductions by private creditors for some, while others saw it as only aimed at 'moral suasion' of private creditors to help out in sovereign debt crises. The latter were, for example, exemplified by the US and UK authorities, but also the IMF itself, who initially took a very reluctant stance towards PSI.[94] In his report to the 1998 IMFC Spring Meeting, Managing Director Michel Camdessus noted that progress should be made with the contractual approach as advocated by the G10, but that most Executive Directors still thought a statutory mechanism impractical and saw no need to proceed further along this line. He was rebuked by the IMFC, however. In their spring 1998 communiqué the IMFC agreed that:

> *when warranted by crisis situations, ways needed to be found to involve private creditors at an early stage, in order to achieve equitable burden sharing vis-à-vis the official sector and to limit moral hazard. While noting the difficult issues involved, the Committee requested the Executive Board to intensify its consideration of possible steps to strengthen private sector involvement.*[95]

The IMFC communiqué mentioned the LiA and CACs as possible avenues for PSI, but not a statutory approach.

The IMF produced a first comprehensive paper in August 1998 that merely outlined possible avenues without aiming for concrete steps forward. Options considered were voluntary private credit lines, CACs, the organisation of creditor committees in advance of crises, and – as a sort of 'nuclear option' – a moratorium on debt payments. The CACs were in the background of the PSI discussion, however, and limited progress seemed to be made by the G10 or IMF (nor on actual implementation, for that matter, see table 5.5 in the next subsection).[96]

No concrete decisions had been made on PSI when the fallout of the East Asian crisis claimed another victim: Russia defaulted on its debts in 1998. This sent shockwaves through the private sector, especially since its bank debts had been rescheduled and securitised under a London Club agreement only in 1997.[97] Suddenly the realisation dawned that if a significant state was unwilling to pay the private sector had little actual leverage. What's more, the Russian default triggered the collapse of the Long-Term Capital Management hedge fund. This hedge fund turned out to be of systemic importance and necessitated a major rescue effort to prevent the collapse of major banks and possible a meltdown of the global financial system.[98] This illustrates the global and cross-sector integration of the financial system that had occurred over the course of the 1990s – and the risks it entailed.

The policymaking process on PSI continued through 1999, mainly in forums dominated by creditor countries. For example, the G7 summit in Cologne (June 1999) formulated 5 rather general and vague principles for PSI. One of the problems was a difference of viewpoint between Anglo-Saxon countries which argued for a case-by-case approach and continental European countries which supported rules-based approaches.[99] In the G7 statement made at the 2000 Spring Meeting the language was strengthened somewhat, demanding more concrete action on PSI.

This concrete action was delivered through the 'Prague Framework', which was the culmination of the policymaking process on PSI and was adopted during the 2000 IMF Annual Meeting in Prague. The IMFC agreed that this operational framework for PSI "must rely as much as possible on market-oriented solutions and voluntary approaches." The option of comprehensive debt restructuring was on the table, as were standstills ("in certain extreme cases").[100] The communiqué did not provide guidance on how this should be done, however. The Prague Framework resembled the recommendations of the Rey report by omitting concrete shifts in governance and consisting mostly of open-ended declarations. The Prague Framework differed from the Rey report, however, in that the official community put more pressure on the private sector to contribute to debt restructurings, and in that sense reflected an adjustment of public authorities' preferences.

In the summer of 2001, the IMF for the first time discussed the relationship of its PSI framework to the Paris Club. As noted in chapter three, the 'comparability of treatment' clause

[92] Confidential document source.
[93] IMF Archives, 30 April 1999, p.2.
[94] Confidential document source.
[95] IMFC, 16 April 1998.

[96] Sometimes CACs were quite literally in the background: confidential IMF documents from 1999 show a paper on CACs providing 'background information' to the main note on PSI.
[97] Gorbunov, 2010, p. 163.
[98] Lowenstein, 2001 provides an interesting journalistic account of this affair.
[99] Confidential document source. This seems to be in line with the analysis of Abdelal, 2007 who argues that the governance of the liberalisation of global finance can be explained by the dynamics of European policymakers seeking to implement rules and Anglo-Saxon policymakers seeking liberalised markets.
[100] IMFC, 24 September 2000.

could have an important impact on the involvement of the private sector by forcing them to follow a Paris Club rescheduling or debt reduction. IMF staff considered the possibility of making the application of the comparability of treatment clause contingent on regaining market access. This was under the assumption that IMF programmes would restore the creditworthiness of debtor states and close the financing gap via the catalytic effect of an IMF programme (while comparability of treatment would deter the private sector from filling the financing gap). Several EDs from creditor states strongly objected to tinkering with the comparability of treatment clause, however, and also pointed out this was a matter for the Paris Club to decide.[101] The policymaking discussions in exclusive clubs were not to be opened up to the entire IMF membership. The staff's suggestion on comparability of treatment was therefore deleted from the published version of the paper.[102]

Putting all the chips on the table: the CACs, Code of Good Conduct, and the SDRM

A decisive turn in the policymaking process came with the election in 2000 of George W. Bush as President of the United States.[103] The financial policymakers he brought in (Paul O'Neill as Secretary of the Treasury and John Taylor as Under Secretary for International Affairs) were highly critical of IMF bailouts. At the same time, the deterioration of the economic situation in Argentina breathed new live in the debate on sovereign debt restructurings. As PSI was mostly voluntary and aimed at preventing a crisis from turning into an actual default, there was still no governance pattern to deal with an actual default in case of an assertive debtor country like Argentina. The worsening of the debt dynamics in Argentina (despite a controversial IMF programme agreed on in August 2001) led O'Neill to testify to the Senate Banking Committee: "We need an agreement on an international bankruptcy law (…) instead of socializing the cost of bad decisions."[104]

It did not take long for the hints by US public officials to be picked up by the IMF (which could build on their earlier 1995 note on a Debt Adjustment Facility for Sovereign Debtors) and in late 2001 First Deputy Managing Director Anne Krueger launched a new comprehensive proposal for a Sovereign Debt Resolution Mechanism.[105] At about the same time, the Banque de France launched its own governance proposal in the form of a Code of Good Conduct (CoGC). The different proposals now under discussion could be characterised on the 'nature of governance' dimension as ranging from 'mostly public' (the SDRM) to mixed (CACs) to 'mostly private' (CoGC). The developments in these three tracks of the policymaking process are discussed in turn below.

[101] Confidential document sources show that the Directors representing Paris Club creditors basically refused to discuss the technical specifics of the Fund's proposal.
[102] IMF, 6 December 2001.
[103] Helleiner, 2008.
[104] Cited by Helleiner, 2008, p. 108.
[105] IMF, 26 November 2001. See also IMF, 30 November 2001.

The SDRM aims to simplify the resolution of sovereign debt crises by creating a process for restructuring under a (temporary) standstill. It builds on an analogy with domestic bankruptcy courts. The initial proposal by Krueger had four key features: (1) prevention of seeking redress in national courts by creditors; (2) adoption of appropriate economic policies by the debtor country as well as starting negotiations with the creditors 'in good faith'; (3) preferred creditor status for new private credit (similar to debtor-in-possession financing); and (4) majority decision-making by creditors.[106] This proposal (even more than the CACs) addressed the situation of countries diversifying their sources of capital. It would cover all outstanding bonds of a country and subject them to an integrated restructuring, overcoming the increasing coordination problems in negotiations. As was to be expected from the IMF, it was the 'logical' response to the changes in the market structure underpinned by (neoclassical) economic theory. It also reflects how the IMF as a public actor formulated its preferences in global financial policymaking independent of market actors.

The original proposal of the SDRM implied first of all a shift in governance to the global level. It would imbue the mechanism with jurisdiction over all outstanding international debts, where the Baker and Brady plans applied to a specific set of emerging markets. It would secondly imply a governance pattern of a decidedly public nature, being based in an international organisation. Krueger was quick to suggest that this could be done by amending the IMF's Articles of Agreement.[107] On the third dimension of governance, it would be stringent for both debtors and creditors as it would impose conditionality on the part of debtors, and could impose majority decision-making on the part of creditors (even if, for example, their debt contracts currently did not include CACs facilitating this).

Anne Krueger subsequently went on a global tour to promote the idea with speeches in India (December 2001) and Australia (January 2002). Creditor member states of the IMF responded to the proposals quite positively, which is surprising given the earlier strong rejection in the 1996 G10 report.[108] It seems that the sheer magnitude of the series of emerging market crises of the late 1990s, combined with the intellectual force and standing of the IMF in the policy community changed the preferences of a significant number of policymakers. For example, in an interview a public official of a major emerging market remarked that the fact that the First Deputy Managing Director threw her weight behind the plan was important for their support of the proposal.[109] Some debtor countries on the other hand – notably Brazil – had already voiced strong opposition to the idea of an SDRM and claimed it would have an adverse effect on capital markets at a time when Brazil was in a very vulnerable position.[110] This illustrates the fear of emerging markets for their position as demand side on the market

[106] IMF, 26 November 2001.
[107] IMF, 20 December 2001.
[108] Confidential document source.
[109] Off-the-record interview with public actor, 2007.
[110] Off-the-record interview with public actor, 2008.

for sovereign debt, and the expected negative private sector reaction to more robust public governance of sovereign debt crises.

It was clear that many issues would have to be addressed in the further development of the SDRM. Fund staff worked expediently and in February 2002 provided a paper addressing how to assess the need for a standstill, the role of the IMF, the legal basis of the SDRM and the scope of its application (which debts would fall under the regime).[111] This paper already suggested a variant of the SDRM where not the IMF, but a majority of creditors would agree with the debtor on a standstill. In other words a shift towards a pattern of governance of a lesser 'public nature'.[112] Notwithstanding, the US ED (and several others) opposed any statutory mechanism in favour of the contractual approach (CACs).[113] Given the US' ability to block changes to the IMF's Articles of Agreement, this was bad news for those in favour of the SDRM. Opposition within the US official sector seemed to come from Under Secretary of the Treasury Taylor (O'Neill was still Secretary of the Treasury and had been in favour, as mentioned above). An off-the-record interviewee assured me that Krueger remained sure she could convince Taylor of the merits of the proposal and overcome his opposition.[114]

Interestingly, just before going public with the proposal, Krueger discussed it in the Capital Markets Consultancy Group (CMCG) of the IMF. This Group had been established after the East Asian crisis and brought top-level private sector executives together with top-level IMF bureaucrats to discuss the world economy and policy initiatives in global finance. At the 13 November 2001 meeting when Krueger tentatively introduced the SDRM, the private sector representatives in the CMCG responded more or less indifferently. It was their view that the complexity of establishing such an SDRM would prohibit the successful implementation of the proposal.[115] After the high-profile launching of the proposal by Krueger, the IIF was quick to voice condemnation, however.[116] At the next meeting of the CMCG (March 2002), private sector representatives had fallen in line with the IIF and pleaded for the contractual approach.[117] An SDRM would adversely affect their terms of competition, in the sense that their position vis-à-vis the demand side (debtor states) might be weakened. This would subsequently likely lead to a higher burden on private actors in sovereign debt crises, negatively impacting their profits.

[111] IMF, 14 February 2002.
[112] A public speech by Anne Krueger in April 2002 reflected this shift to a lighter role of the IMF (IMF, 1 April 2002).
[113] Confidential document source.
[114] Off-the-record interview with public actor.
[115] Confidential document source.
[116] IIF, 17 December 2001. A confidential document source reporting on a meeting with Dallara (Managing Director of the IIF) shows how shrill IIF opposition to the SDRM was. He called the SDRM a complete abrogation of creditor rights and an obstacle to globalisation (underscored in Dallara's view by the fact that 'anti-globalisation' NGOs like Jubilee 2000 were supportive of the proposal). This shrill tone in debates was also evident on two other occasions involving high-level IIF representatives (interview IIF, Washington, 25 June 2008 and presentation of Tom de Swaan to the first annual GARNET conference, 29 September 2008).
[117] Confidential document source.

By early 2002, it was clear that both the private sector and the US authorities were in favour of the contractual approach instead of the SDRM. Support by the European countries was unwavering, and the IMFC stated after the Spring Meeting that it:

> *welcomes the consideration of innovative proposals to improve the process of sovereign debt restructuring to help close a gap in the current framework. It encourages the Fund to continue to examine the legal, institutional, and procedural aspects of two approaches, which could be complementary and self-reinforcing: a statutory approach, which would enable a sovereign debtor and a super-majority of its creditors to reach an agreement binding all creditors; and an approach, based on contracts, which would incorporate comprehensive restructuring clauses in debt instruments.*[118]

Over the course of 2002, the proposals of the IMF were adjusted to exclude the IMF from being involved in judging the 'good faith' of the negotiations. The IMF would not have any formal role; instead an independent dispute resolution forum would be established.[119] Another of the outstanding issues concerned the coverage of debts under the SDRM. The private sector had already put into question the preferred creditor status of the International Financial Institutions and the possible exceptional position of bilateral loans under the SDRM. The Paris Club secretariat therefore took the initiative to clarify their relation to the SDRM in February 2003. Although no decision had yet been taken whether to include official bilateral claims in the SDRM, it was noted that there was an awkward relation between an SDRM agreement and comparability of treatment. An SDRM agreement could possibly force a restructuring on official creditors as well (known as 'reverse comparability of treatment', and strongly rejected by Paris Club representatives).[120] The Paris Club took the position that comparability of treatment and the sovereignty of official creditors should be preserved. The Paris Club debt should consequently stay out of the SDRM, and if an eventual SDRM agreement did not fulfil the comparability of treatment clause, the Paris Club agreement would be cancelled.[121] The SDRM would therefore only cover the 'private' part of the market for sovereign credit.

Pressure among the policy community to reach a conclusion had increased in the meantime: in its September 2002 communiqué the IMFC requested a concrete proposal for an SDRM at its next meeting (Spring 2003).[122] In the run-up to this concrete proposal negotiations and lobbying intensified. The private sector – led by the IIF – opposed the SDRM with increasing vehemence. The IIF lobbied the IMF directly, for example through its policy briefs in advance of the Fund's Spring and Annual Meetings. Also, the IIF broadened its coalition

[118] IMFC, 20 April 2002.
[119] IMF, 12 November 2002.
[120] Confidential document source.
[121] Confidential document source.
[122] IMFC, 28 September 2002, para. 11.

by joining forces with associations like the Emerging Market Creditors Association (EMCA) in what became informally known as the 'Gang of Six'. The emergence of the Gang of Six reflected an increasing integration of financial markets for sovereign debt (covering both banks and capital market parties) and had a strong preference for market-based solutions (which includes CACs) to sovereign debt crises.[123] In December 2002, the Gang of Six even threatened to withdraw its support and efforts with respect to the implementation of CACs as long as discussions on the SDRM continued.[124] Lobbying activity of the private sector increased in intensity in the official sector's preparations for the spring IMFC meeting. The traditional IIF position paper was being supported by visits of high-level domestic banking executives to finance ministers and central bank governors.[125]

Public officials of the G10 increasingly recognised that their support for the SDRM was developing into a leverage instrument to get the private sector to commit to CACs.[126] Emerging markets, in apparent reaction to private sector opposition, in the meantime seemed to oppose any regulation of international capital flows. They feared that their position on the demand side of sovereign credit would suffer from higher borrowing costs.[127] As another blow weakening the case for the SDRM, Mexico emitted the first international bond including CACs under New York law. The Mexican Finance Minister later admitted that the main reason to include the CACs was "to get rid of the SDRM."[128]

As requested by the IMFC, a concrete proposal was tabled in the 2003 Spring Meeting.[129] Given the opposition from all sides and the faltering support, the SDRM was shelved. This was partially the result of the voting weights in the IMFC. A majority of (European) EDs seemed to support the proposal. However, the US' veto power combined with the lesser voting weight of emerging markets defeated the proposal. The market-based CACs were to be the only substantial change in the governance of sovereign debt crises on the public side, and this track in the policymaking process is discussed next.

Coming to the second track in the negotiations, the G10 decided in response to the debate on the SDRM that it could provide added value to the discussions by developing 'model' CACs. A G10 working group under the leadership of Randal Quarles (US Treasury) was established in June 2002.[130] The working group held informal consultations with the private sector and received encouraging signals. Some private sector representatives indicated they were working on their own model clauses, but the G10 working group tried to co-opt that process

[123] The Gang of Six consists of the Bond Market Association, EMCA, Emerging Markets Traders Association (EMTA), International Primary Markets Association (IPMA), IIF and the Securities Industry Association.
[124] Gang of Six, 6 December 2002.
[125] For example, a delegation of ABN AMRO and ING (both banks closely involved in the IIF) paid a visit to the Dutch Finance Minister, which led to a slight softening of Dutch support for the SDRM.
[126] Confidential document source.
[127] Informal communications with emerging market representative.
[128] LatinFinance, December 2003, p. 24.
[129] IMF, 25 March 2003.
[130] G10, 26 September 2002.

by including them in their drafting exercise.[131] The actual drafting of the clauses was in any case subcontracted to private sector lawyers. The private lawyers were also expected to advise on the 'market acceptability' of the proposed CACs, meaning the degree to which financial firms would support including CACs in international bonds.[132]

In July 2002 the IMF discussed the state of affairs with respect to CACs (and considered its options to encourage greater use of CACs). The staff paper noted that the private sector (represented by the EMCA) tried to raise the majority threshold for decision-making as high as possible (to 95%), remarking that this would defeat the purpose of CACs. Furthermore, the official endorsement of CACs by the G10 and IMF had not yet had an impact on market practice by 2001. Even if CACs would become market standard, it would take decades for CACs to cover all outstanding bond debt. Despite this discouraging progress on CACs, the Fund only committed to encourage the use of CACs under its surveillance. The inclusion of CACs under programme conditionality (which would be quite effective) was rejected by the EDs. With the exception of the US, the EDs furthermore noted that given the long implementation time, proceeding with the SDRM was also adamant.[133]

In the negotiations on CACs, the private sector consequently set out mainly to limit the restrictions on their freedom of manoeuver (by setting a very high majority threshold). The IMF, on the other hand, was seeking ways to pressure debtor countries but did not obtain a stringent mandate to do so through conditionality.

The report with model clauses was presented as early as the September 2002 Ministerial G10 meeting (which is held parallel to the IMF Annual Meetings). The main objectives for the model CACs were (i) to foster early dialogue, coordination and communication among creditors and a state caught up in sovereign debt problems; (ii) to ensure that there are effective means for creditors and debtors to re-contract without a minority of debt holders obstructing the process; and (iii) to ensure that disruptive legal action by individual creditors does not hamper a workout that is underway, while protecting the interests of the creditor group. The report furthermore noted that the approach should build on market practices and build a consistent framework across jurisdictions. An important feature of the CACs was the majority decision-making threshold, which was set at 75 per cent according to practice under English law. Discussions with prominent emerging markets showed that these were still hesitant to implement CACs (as was the private sector).[134] During the meeting several G10 members (again, not including the US) emphasised that work on the 'other track' (the SDRM) should continue.

[131] Confidential document source.
[132] G10, 26 September 2002, p. 2.
[133] IMF, 26 July 2002, p. 4 and confidential document source.
[134] Confidential document source. The communiqué of the meeting emphasised that the statutory and contractual approaches were complementary. G10, 27 September 2002.

In January 2003 the 'Gang of Six' came up with its own counterproposal for CACs – despite its threat to withdraw support a month earlier, as mentioned above. Compared to the G10 standard, this proposal sought greater standardisation of the clauses, and set more stringent norms for transparency of debtor countries.[135] Also its majority voting thresholds were higher than the G10 model clauses (85 vs 75 per cent). Notably, the IMF did not commit to the G10 model clauses specifically, but endorsed clauses in general (including those developed by the private sector).[136] This reflected a rift between the European EDs (in favour of endorsing the G10 clauses) and the US and emerging market EDs (against endorsing a specific set of clauses).[137]

Around the same time, a landmark study by Eichengreen & Mody on the potential costs of CACs was published.[138] This study was based on the experience with CACs under English law. They concluded that CACs would not increase borrowing costs for more creditworthy emerging markets, but would increase spreads for less creditworthy debtor countries. In other words, the effect of CACs on the terms of competition would be limited. The demand side of the market would not unduly suffer from including the clauses.

Creditor countries were in the meantime also discussing in several different forums (G10 and the Ecofin) whether to 'lead by example'. The EU decided in September 2002 to do just that, but given the very limited issues of foreign currency bonds (about 3.5 per cent of the outstanding European stock), this was a bit of an empty gesture.[139] Nevertheless, as mentioned above, in February 2003 Mexico announced its plan to issue bonds with CACs that were based on the private sector's proposals as well as the G10 model clauses. These bonds included a 75 per cent majority voting threshold, and were closer to the G10 clauses than to the private sector's model according to the IMF.[140]

The G10 was pushed by the Bank of England to pursue monitoring of the implementation of their model CACs. In a study published by the BoE, it was concluded that although the use of CACs had increased significantly after 2002, the CACs used conformed only to the second objective of the G10 model clauses (effective means for debtors and creditors to re-contract), while the objectives of fostering dialogue and avoiding disruptive legal action were not addressed. While the rise in the use of CACs had started earlier, that was due to the increase in market share of London (which includes CACs), while the use of CACs in New York bonds was non-existent until 2003 (see table 5.5 below).

[135] Gang of Six, January 2003. See also IMF, 25 March 2003, p. 7.
[136] IMFC, 12 April 2003.
[137] Confidential document source.
[138] Eichengreen & Mody, 2004. Earlier versions of this paper had been circulating among policymakers since 1999 and a version containing the same empirical claim was published in 2001 as an IMF Staff Paper.
[139] IMF, 25 March 2003, p. 19. In January 2000, the UK did include a majority amendment clause in a euro-denominated treasury note, however, without effects on price and liquidity (IMF, 25 March 2003, p. 18-19).
[140] IMF, 25 March 2003, p. 20–22.

Table 5.5 Foreign currency sovereign bond issuance by governing law 1995 – 2004 (billion US$)

Governing law	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04*
New York	7.1	21.3	22.0	18.0	22.2	34.7	37.2	36.3	46.7	33.4
(w CACs)									(21.8)	(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***

* 2004 to 30 September   Source: Drage & Hovaguimian, 2004, table 1 (p. 3)

The CACs consequently turned out to be a successful track in the policymaking process. However, as mentioned above, there was also a third track in the governance of sovereign debt crises. Policymakers had concluded that there might be other ways of dealing with fostering early dialogue, to wit a Code of Good Conduct. The CoGC was initially proposed in 2001 by Jean-Claude Trichet, at the time Governor of the Banque de France.[141] He saw the Code as something to be embraced by both the public and private sector. At the 2002 IMF Annual Meetings Trichet pushed for the Code in his intervention ("we should without delay build upon work already done to write down a code of appropriate conduct for concerted and informal debt restructuring").[142] It was not taken up in the IMFC communiqué, however, which only focused on the twin tracks of SDRM and CACs (the latter to be developed by the official community, private creditors and sovereign debt issuers).[143]

However, outside of the G10 group calling the shots in the IMFC, Trichet found a listening ear in the private sector (notably the IIF) and at the G20 meeting of finance ministers and central bank governors. The latter supported further work on the Code in its 2002 communiqué.[144] It seems likely that this was mainly the result of support by the emerging market economies in the G20, as the G10 did not explicitly support the development (and it was also not taken up in the IMFC). Only in October 2004 did the G10 encourage "sovereign debtors and private creditors to continue their work on a voluntary set of principles on sovereign debt restructurings."[145]

In January 2003, the Banque de France presented an issues paper 'Towards a Code of Good Conduct on Sovereign Debt Re-Negotiation.'[146] This seemed mostly to be in response to

[141] Ritter, 2010, p. 225.
[142] Trichet, 29 September 2002.
[143] IMFC, 28 September 2002.
[144] Ritter, 2010, p. 226.
[145] G10, 3 October 2004.
[146] Banque de France, January 2003.

the loss of momentum on the crisis resolution policy domain (with the SDRM effort derailed and little apparent progress on CACs). The CoGC was presented as a complement to these two and echoed the Prague Framework for PSI. The CoGC therefore also mentioned a 'toolbox' for PSI, including rollovers, standstills and bond exchanges.

The Banque de France issues paper seemed to build on the expectation that this would be a proposal that would get the different parties around the table in a constructive dialogue again, as opposed to the confrontational debates with the private sector on CACs and the SDRM. It was even noted rather optimistically that: "The CGC rather fills the present vacuum and offers a workable way for allowing – as pragmatically and realistically as possible – all stakeholders to optimize their present behaviour and, perhaps, *to accept tomorrow what they do not accept today.*"[147] The paper called for inclusion of a wide range of stakeholders in the discussions (meaning public and private creditors, sovereign debtors, the financial community as a whole, and the IFIs) and called for a subsequent endorsement by these same parties.

The CoGC was supposed to lead to orderly solutions to excessive indebtedness through early engagement with creditors, fair information sharing, fair representation of creditors, comparable treatment among creditors, fair burden sharing, negotiation in good faith, preservation of the debtor's financial situation and restoring debt sustainability as soon as possible. After some discussion in the official policy community, further development of the CoGC was relegated to a working group led by the Banque de France and the IIF which included some important debtor countries.

The IMF was encouraged to contribute to the development of the CoGC.[148] The IMF reported in September 2003 that the mixed group of stakeholders had difficulty coming to operationalised principles. The Fund furthermore noted that although it participated in the CoGC discussions, its policies would remain a prerogative of the Board and not be affected by a CoGC.[149]

The lack of progress was apparently due to the intransigence of debtor countries, and it was not until mid-2004 that discussions were reignited. Interestingly, some creditor associations (EMTA/EMCA) seemed to be pushing for a more stringent CoGC with IMF monitoring (in the sense of being stringent for debtor countries, of course). This was opposed by the debtor countries.[150]

In October 2004 the IIF and IPMA agreed on a text with Brazil, Mexico, South Korea and Turkey. This core group subsequently started seeking wider support in the private sector and among debtor countries.[151] In November 2004 the renamed 'Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets' were presented by the IIF, IPMA

[147] Banque de France, January 2003, p. 2 (emphasis added).
[148] IMFC, 21 September 2003. As soon as the private sector became involved, the Code of Good Conduct was shortened to Code of Conduct; apparently the private sector does not have to be good…
[149] IMF, 5 September 2003, p. 11.
[150] Confidential market source.
[151] Confidential market source.

and the four emerging markets. The emphasis in the 'Principles' had shifted from actual debt restructuring to crisis prevention through more debtor transparency and dialogue with creditors. The PSI toolbox had, for example, largely disappeared. The principles were to be applied on a case-by-case basis and aimed to be market-based, voluntary and flexible.

The Principles were 'welcomed' and 'supported' the same weekend by the G20 finance ministers and central bank governors in Berlin. They were notably not 'endorsed', as some of the provisions seemed to restrict IMF action and, moreover, the public sector did not want to interfere in the 'voluntary and market-based' Principles.[152] Although the press release seemed enthusiastic enough (Trichet speaking of 'an important milestone'), interviews with public sector officials showed them on several occasions rather dismissive of the Principles.[153]

Although there was clear involvement of the private sector associations, it seems that in early 2005 working knowledge on the micro level (traders) of the Principles was limited and reservations still existed among the membership of the associations.[154] Implementation only took off in late 2005 when the Principles Consultative Group (PCG) and a Group of Trustees of the Principles were established.[155] Both are high-powered groups filled with top-level public officials and ex-officials who now work in the private sector. For example, as of 2010, the chairmanship of the Group of Trustees is shared by Jean-Claude Trichet (ECB President), Henrique de Campos Meirelles (Banco Central do Brasil Governor) and Toshihiko Fukui (former Governor of the Bank of Japan).[156]

To sum up, different patterns of governance were proposed in response to the new market structure of capital market financing of sovereign debts. All of these proposals shifted governance upwards to the global level, but implied rather different shifts across the other two dimensions. The three 'tracks' differ on the 'nature' of governance dimension from mostly public (SDRM) to mostly private (Principles). The stringency also ranges from more stringent (SDRM) to less stringent (the voluntary Principles). In the end, only the more market-based proposals had come to a successful conclusion (CACs and the Principles). The next section will provide an analysis of the policymaking process that has been described above and concludes this chapter.

[152] G20, 21 November 2004. A practical reason also seemed to be that the EU did not have the time to coordinate their position towards the Principles, and consequently the EU representative in the G20 simply could not endorse them. Furthermore, the Argentines were strongly opposed to the Principles. Confidential document source.
[153] Off-the-record interviews with public actors, 2007-2008.
[154] Confidential document source.
[155] Ritter, 2010, p. 228.
[156] An up-to-date list can be found on the IIF website. For 2010, other members include Brady (currently chairman of Darby Overseas Investments), de Larosière (currently Advisor to the Chairman of BNP Paribas Group) and Andrew Crockett (now President at JP Morgan, former Secretary-General of the BIS).

Analysis and preliminary conclusions

The process tracing above has shown the complex interplay between market structures and shifting patterns of governance. It was shown how the case of sovereign debt restructuring essentially involves bargaining between three main actors involved in global debt markets: debtor states, private creditors, and creditor state authorities and IFIs. As the terms of competition and the market structure changed, the positions of these different parties in this bargaining process strengthened or weakened, and preferences for governance of this bargain were revised. The ensuing policymaking process led to important shifts in governance. In the following two subsections, the analysis starts with addressing the first research question (how have the patterns of governance and market structures changed). The second subsection analyses the characteristics of the policymaking process (second research question) and the relation of the patterns of governance to the changes in market structure (third research question).

Shifts in governance from the Baker Plan to the Principles

As an opening remark, it might be noted that both the Baker and Brady plans were only 'temporary' governance patterns, in the sense that they were an ad hoc response to the Latin American debt crisis and as such they entailed a governance pattern that 'disappeared' after that crisis was solved. That being said, the pattern of governance of sovereign debt crises has since shifted in a number of ways. With respect to the first dimension of governance (jurisdictional level), both the Baker and Brady plans can be seen as international level governance patterns. The plans set rules guiding the sovereign debt restructuring of the emerging markets in crisis (while the problems were mostly concentrated in Latin America, emerging countries in all corners of the world experienced problems). What's more, banks affected by the governance pattern were spread all over the Western world. On the other hand, both plans were aimed at the crisis-ridden countries and their creditors only.

The post-Asia crisis governance pattern shows a shift towards more global level governance as the CACs and Principles apply to all countries issuing international bonds or debt and to all their creditors. The same applies to the prospective SDRM. In that sense, it was argued that a limited shift upwards on the first governance dimension had taken place. For the first time a governance pattern applying to all countries with (private) international debt was implemented.

Coming to the second dimension of governance, its nature, the Baker and Brady plans were public initiatives. Designed by US Secretaries of the Treasury and administered by the IMF. Within the framework of this public governance pattern, debtor states and private creditors negotiated a solution for the sovereign debt crisis. Thus, although private actors were naturally involved in the eventual negotiations (they were the creditors having to restructure debt, after all), the framework was administered by public authorities.

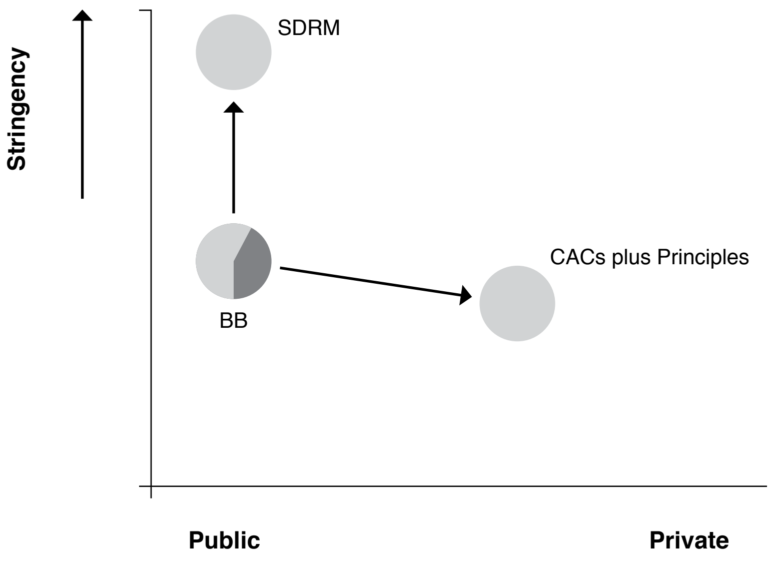
After the East Asian crisis had signalled the costs of new forms of risk to the market players, this ad hoc framework for sovereign debt restructuring changed significantly. The proposal with the most public nature (the SDRM, in first instance envisaged as an international organisation comparable to a bankruptcy court) was defeated by a combination of a standard for CACs (with a public nature) and the Principles (which are of a private nature). Although the standard for CACs is public, its actual implementation is left to the market and is voluntary (debtor states acting as the demand side of the market for sovereign debt and private creditors). The CACs can consequently be seen as a mix between public and private governance. This therefore entailed a shift towards more private actor-based governance compared to the Baker and Brady plans.

On the third dimension a particularly interesting shift takes place. The starting point after the Latin American debt crisis was based on IMF conditionality for the debtor countries (which restrains domestic policy space) and co-financing demands on private creditors. The co-financing demands were to a certain extent stringent for private creditors in the sense that pressure was exerted by the IMF and central banks and ministries of finance to fulfil them, and they consequently 'overruled' normal market processes (which would call for a reduction of lending). The LiA policy did not so much change the stringency of the governance pattern, but it did change the power balance between the three parties involved slightly in favour of the debtor states.

The governance pattern implemented after the East Asian crisis (CACs and Principles) has one thing in common regarding stringency: the two elements set rules for the negotiations between debtor and creditors, and not so much rules for the outcome (as Baker and Brady did to a larger extent). In that sense, the governance pattern is less stringent and more open-ended than Baker and Brady. This is especially the case for private creditors, as they are no longer forced to adjust their lending policies, but have a say on a possible restructuring. The majority clauses in CACs are somewhat constraining for private creditors (especially holdout creditors such as vulture funds). Had the SDRM materialised, it would have entailed a stringent governance pattern for both debtor and creditors alike, as it would be able to set binding terms for restructurings.

In figure 5.1 on the next page, the shifts in governance from the Baker and Brady plans to CACs plus the Code of Conduct are schematically illustrated. An assessment of the shifts in governance the SDRM would have entailed is also included. As in figure 4.1 in the previous chapter, the vertical axis represents the stringency dimension (the further from the zero-point, the more stringent), while the horizontal axis depicts the nature of governance dimension (public at the zero-point, adding more private elements the further we move away from the zero-point). The pie chart in the circles representing the different governance patterns reflects the jurisdictional dimension: a larger lightly shaded area represents a shift upward to the global level.

Figure 5.1. Shifting patterns of governance: Baker/Brady (BB) to SDRM vs CACs plus Principles.

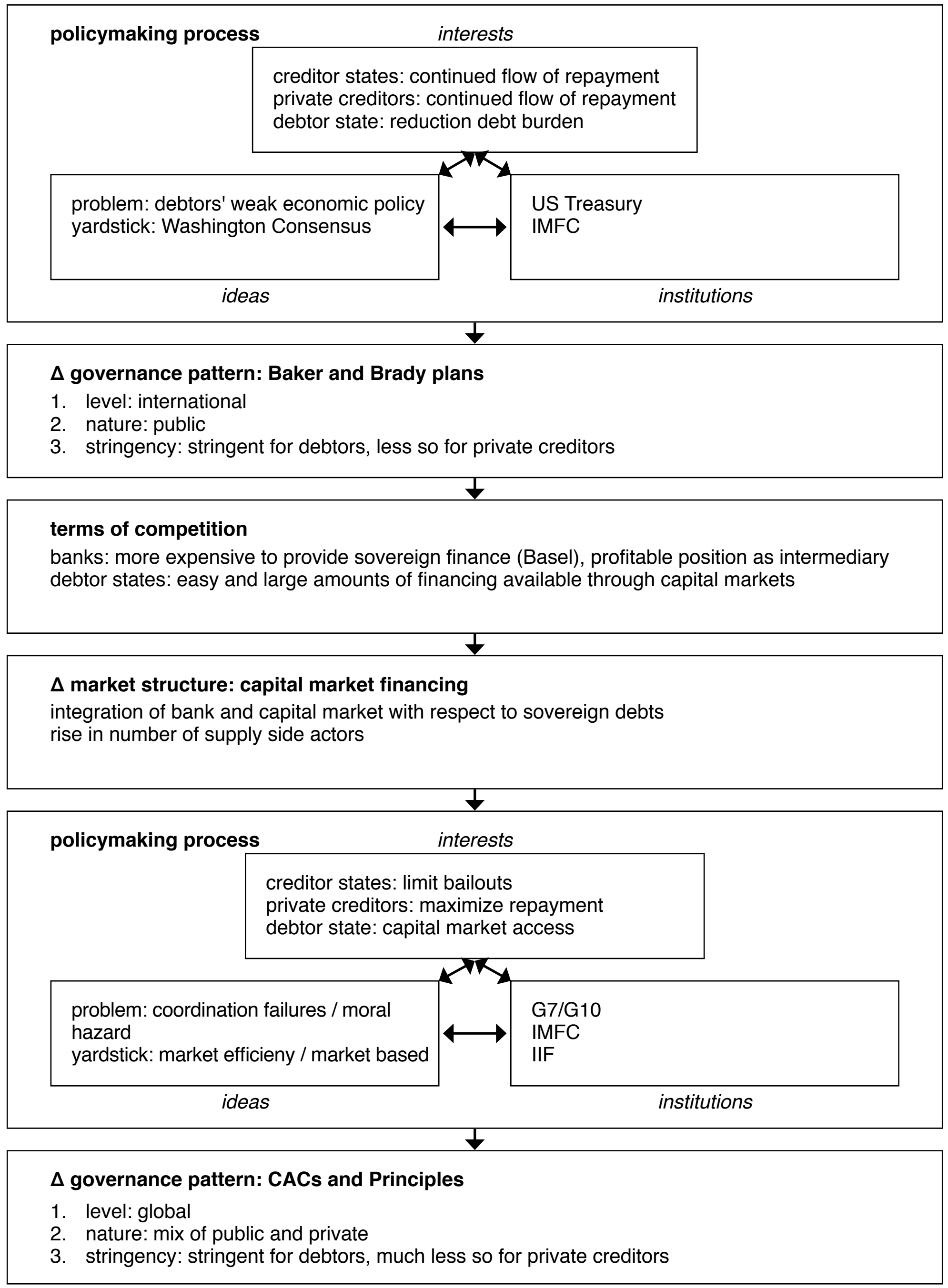


The feedback dynamic at work in the market for sovereign debt

As figure 5.1 above shows, in the policy domain of sovereign debt crisis resolution there has been a limited shift upward on the jurisdictional dimension, a more pronounced shift towards governance of a more private nature, and a clear shift towards patterns of governance that are only stringent in the sense of setting rules for the negotiating process between public debtors and private creditors (thereby empowering market actors and being market-based). The shifts can be explained by applying the analytical framework as developed in the theory chapter.

The following analysis is focused on the time period of this chapter and thus 'steps into' the feedback loop at the point where the Baker and Brady plans were being negotiated. In the concluding chapter the analysis from this chapter will be extended with that of chapter three, including the developments of the 1970s. Figure 5.2 on the next page shows the feedback loop that was introduced in the first chapter (figure 1.1) is represented in a linear fashion, making one and a half 'rounds'. Starting from the policymaking process in response to the Latin American debt crisis (leading to the Baker and Brady plans) we move to the shifts in governance entailed by the Baker and Brady plans and on to the changes in terms of competition and market structure (first full round). Subsequently the (partial) 'second round' starts with the negotiations on the SDRM, CACs and Principles and ends up with the shifts in governance the CACs plus Principles pattern of governance entailed. In the following, this feedback loop will be elaborated.

Figure 5.2 Linear representation of the feedback loop between market structure and governance pattern in the case of the resolution of sovereign debt crises



The response to the Latin American debt crisis was focused on maintaining the soundness of the global financial system. In other words, creditor states and private creditors had a (strong) preference for a continued flow of repayments to private creditors while debtor states had a preference for a reduction of the debt burden. The close alignment of official US preferences and the preferences of their internationally active banks led to plans that put the burden of adjustment primarily on debtor countries, accompanied by official refinancing (and limited private refinancing). This governance pattern could emerge because of the strong weight of the US in the primary international policymaking institution (the IMFC) – inasmuch the US did not unilaterally design the governance pattern. Furthermore, both public and private actors in the immediate period after the Mexican default coalesced along the view that the crisis was the result of weak economic policies in the debtor countries, and that the solution should consequently focus on improving their policies. This was reflected in the conditionality attached to the IMF programmes under the Baker and Brady plans (which were later baptised the Washington Consensus).

The Brady plan was designed to provide incentives for the creation of a secondary market for sovereign debts, and by creating these also provided the foundation for a primary market in emerging market debt. Viewed from the side of public authorities, these incentives rested on the underwriting of Brady bonds. As regards the banks, they had the additional incentive of the profitability of acting as intermediaries placing sovereign bonds in the market. Many banks thus made the strategic decision to leave the sovereign debt market as lenders, and bonds emerged as the substitute for sovereign bank lending. The Brady pattern of governance consequently led to a change in market structure towards capital market funding of debtor countries and increased integration of the banking and capital market. As it turned out, capital market funding for emerging markets was readily available (which seemed beneficial for the demand side of the market).

Another lasting result of the resolution of the Latin American debt crisis under the Baker and Brady plans was the institutionalisation of a banking lobby at the international level in the form of the IIF. As described in chapter three, this private sector association was instigated and supported by public authorities like the IMF. It evolved out of the bank steering committees addressing the debt crisis into a policy advocacy group that was to become the prime interlocutor of global level official policymakers (IMF, G7 authorities). This strengthened the voice of the private sector in subsequent policymaking processes (as will be elaborated below).

Over the course of the early 1990s, the changes in market structure began to consolidate, and international bonds as a share of outstanding sovereign debts increased. At the same time, banks reduced their direct exposure through bank lending. This new capital market financing could also increase coordination problems in case of sovereign debt problems, however. With bonds thinly spread among thousands of more or less anonymous creditors in many jurisdictions (instead of several hundred banks in a few jurisdictions for the largest syndicated loans), it would become more difficult to negotiate and enforce debt restructurings. Furthermore, the sheer amount of money involved had increased, which could potentially mean ever higher official financing for crisis-ridden countries (money which would effectively bail out private creditors).

The 1994 Mexican crisis underscored the new nature of sovereign debt crises and led to a revision of the preferences of creditor countries' authorities and the IMF. Perhaps the realisation that the IMF's resources were no longer adequate to fulfil its mandate in this new capital market-financed world aided the revision of these preferences. The new market actors (bondholders) somehow had to be involved in the resolution of sovereign debt crises.

However, the dominant policymaking institutions in the domain of sovereign debt restructuring (especially G7/G10) had an exclusive membership with a high level of access for private actors (mainly the IIF and its members). This had led to a skewed argument pool focusing on 'market-based' governance patterns. Possible measures taken had to improve market efficiency (e.g. through transparency in the debate on crisis prevention). The policy discussions on sovereign debt restructuring were therefore delegated by the G7 to the creditor forum of the G10, while preliminary discussions in the IMF Board on a statutory mechanism were smothered.

The 1997-1998 East Asian crisis and the associated large-scale official lending packages for many countries drove the point home to creditor countries' authorities. Policy discussions on a new pattern of governance for sovereign debt crises started in earnest. Also, the sheer size of this crisis seemed to open a window of opportunity for different voices to be heard in the policy discussions. Global financial governance was suddenly at the centre of attention and a whirlwind of governance proposals ensued.

Yet, the main policymaking institutions (the IMFC and G7/G10) did not adjust their market-oriented ideology. The exclusionary nature of these policymaking institutions led to scant debate of 'radical' reform proposals that would, for example, lead to more public and stringent governance patterns (e.g. capital controls) and instead focused in first instance on CACs. When the G10 revealed their model CACs this amounted to a global level standard of a public nature that would set regulations for the process of negotiations between debtors and creditors and in that sense restrained their behaviour. This reflected only a limited shift at the jurisdictional level, which is understandable as contagion ensures that big crises become global in scope. The Baker and Brady plans were consequently already close to being global level plans, and there was no reason for further shifts along this dimension. However, the standard was vague on the outcome of these negotiations and in that way was much less stringent for private actors than the Baker and Brady plans.

Implementation of CACs was initially limited (not to say non-existent), and sovereign debt crises continued (most notably Argentina which defaulted in 2001). This led the IMF to launch the SDRM, seemingly egged on by the US Secretary of the Treasury. This global level governance pattern of a public nature would function as a bankruptcy court and in a sense was more stringent than the Baker and Brady plans.

Interestingly, private sector involvement in the negotiations was initially limited. The new market structure had not yet led to a significant revision of preferences, and the proposals so far were market-friendly. The involvement of the IIF in the policymaking institutions had ensured market-based governance patterns that could even be ignored in their implementation (the CACs). As the momentum for the SDRM built, however, it quickly became clear how the policymaking institutions allowed international private sector actors to satisfy their preferences for lax governance patterns: opposition from the private sector and emerging markets led to the burying of the proposal. The private sector's opposition was strengthened by the fact that emerging markets themselves feared for their terms of competition in the market, meaning they would either loose access to capital markets or be required to pay higher spreads vis-à-vis other possible investments.

However, private sector interests are not entrenched enough to pre-empt all creditor authorities' preferences. At any rate, the problems which would have been addressed by an SDRM were unlikely to disappear. This serves to explain the acceptance (and implementation) of the CACs and the design of the private sector-led Principles. This goes to show that state actors are still influential in the age of global capital markets, even if the skewed argument pool means they share the same broad outlook on things as the private sector. The outcome of the process reflects a compromise between public sector authorities' preferences for 'economically sound' and intellectually rigorous proposals and the preferences of private sector actors to maximise leeway in order to ensure a comfortable competitive position and profits.

In summary, we see increasing internationalisation of the market being accompanied by pressures for global level, market-based governance patterns in order to deal with sovereign debt crises. Support from public actors for more stringent forms of governance is defeated in policymaking institutions with a strong position of private sector interests and a general market-oriented ideology (in other words: the yardstick for solutions is addressing 'market failures' in a way that does not interfere with market processes). The emergence of global level policymaking institutions is therefore an important explanatory factor in the emergence of 'governance light'. In practice, the governance pattern means most of the costs of sovereign debt crises are still born by the general public in poor and emerging market countries, while creditors have considerable leverage to get repaid.

It remains to be seen, however, whether this 'governance light' can deal with possible sovereign debt restructurings in the Eurozone as a result of the current crisis. The problems of emerging market countries have suddenly come close to home in some erstwhile creditor countries. The effects of the crisis on the governance pattern for sovereign debt restructuring will be further discussed in the concluding chapter.

Chapter 6

Global financial governance in the wake of the crisis

This thesis started off with an anecdote about the near collapse of IKB Deutsche Industriebank in the ongoing financial crisis that began in 2007. Unfortunately, these kinds of anecdotes can be situated almost anywhere in the world: from Iceland where the entire banking sector collapsed, to the Netherlands where several banks needed state support, to Dubai where the first in what later became a longer series of sovereign debt crises occurred. Hubris went before the fall, as many iconic industry names suddenly came knocking on the state's door to obtain rescue funds.

But where the socio-economic consequences of this crisis have been severe and enduring for many people who lost homes, livelihoods or opportunities in life, at the time of writing the salary bonus bonanza has once again started at the top banks. We can safely say the benefits of global financial integration have been distributed unevenly. Yet, it is not clear whether the current crisis (the biggest economic malaise since the Great Depression) will lead to a significant reorientation of the workings of the global financial system. The relationship between the latest round of changes in the market structure and patterns of governance remains unclear. Why does it not seem possible to find a pattern of governance that mitigates the risks and effects of financial crises?

It is this concern about the instability of financial systems and their distributional impact (in good times and bad) that provided the foundation for the overarching question of this thesis: What explains the relation between market structures and patterns of governance, so as to understand the dynamics of the global financial system? This overarching question was broken down into three research questions:

1. How has the pattern of governance shifted in the two policy domains of bank capital adequacy standards and sovereign debt crisis resolution over the period 1980 - 2005? How have the relevant market structures changed over the same period?
2. What are the characteristics of the policymaking process leading to these shifts in the pattern of governance of the two policy domains in global financial governance?
3. What is the role of the policymaking process in both shifts in governance and changes in market structure? In short, how do shifting patterns of governance relate to changes in market structures?

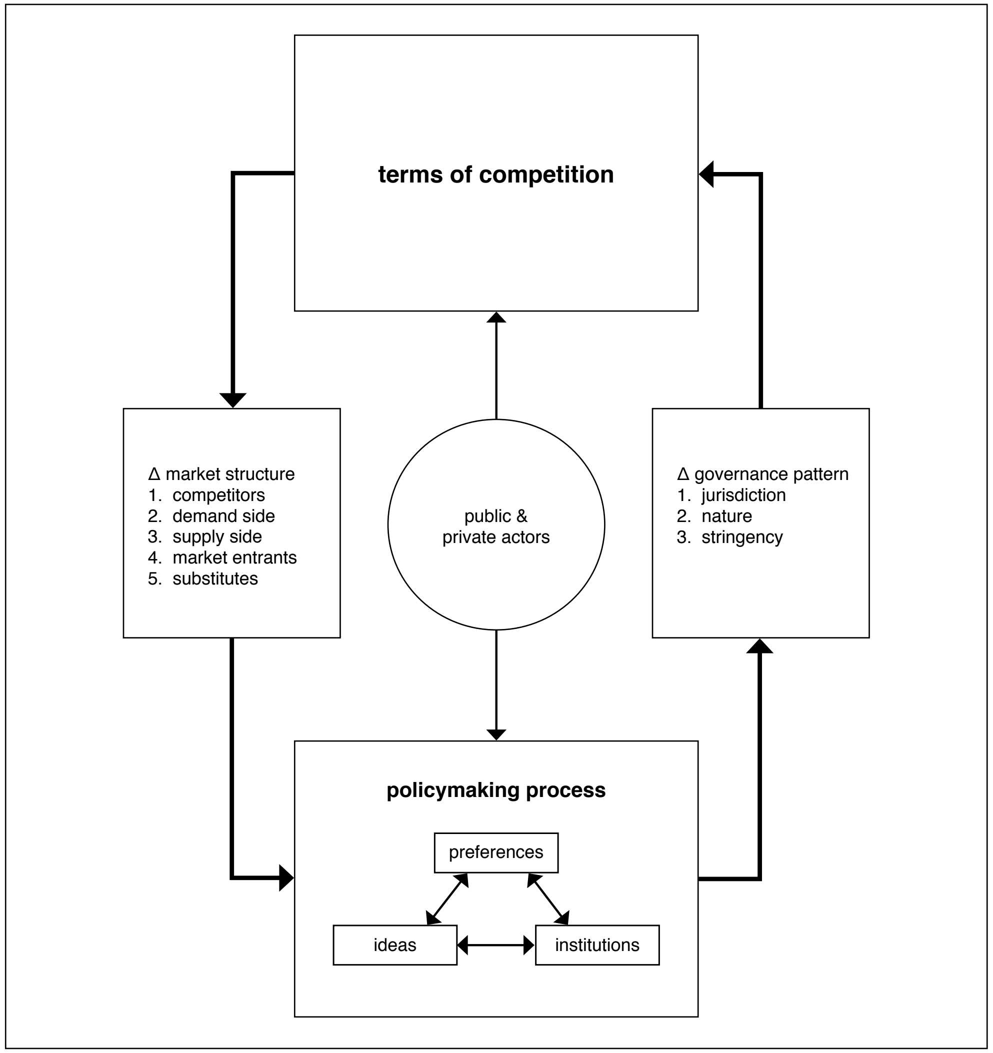
In this final chapter, the findings from the study as presented in this thesis will be summarised and the questions above will be answered. This will be the main focus of the next section, which builds on the preliminary conclusions of the two case studies to come to overarching conclusions and provide an elaboration on how these contribute to the current literature. Naturally, the turbulence since 2007 begs the question whether these conclusions have not been overtaken by current events. The second section therefore turns to the current crisis and how it has affected the policy domains of this study. It is shown that the current turmoil has to date had no significant implications for the analysis of this thesis (other than to underscore its main points). The third and final section explores the implications of the findings for IPE scholars, policymakers and – most importantly – concerned citizens.

Global financial governance: 1980 - 2005

The research questions were addressed through two case studies: one on bank capital adequacy standards and one on sovereign debt crisis resolution. Before the conclusions that can be drawn from these case studies will be discussed, first of all the proposed linkage in this thesis between market structure and governance pattern will be reintroduced. In the second chapter a theoretical model for analysing the dynamics in these cases was advanced that works through the policymaking process. This policymaking process provides for a feedback loop between market structures and governance patterns.

The different elements of this theoretical model will be briefly reintroduced here at an analytical level; in the subsections below the actual application to the case studies will provide more 'meat on the bones'. To graphically illustrate the theoretical model, figure 2.1 from the theoretical chapter is repeated on the next page.

Figure 6.1. The interaction between governance and market structure



To understand how the policymaking process regarding patterns of global financial governance works, the interplay between interests, ideas and institutions must be analysed. This thesis suggests a conceptualisation of this interplay where the 'interests' are the revealed preferences of the actors. The preferences of the actors are expressed in policymaking institutions, which in practice has the effect of excluding the expression of certain preferences from the policymaking process. This can lead to skewed argument pools and groupthink. The result is the formation of a 'yardstick' to measure the proposed governance patterns against that is biased towards those with access to the relevant policymaking institutions (the ideational factor).

As this thesis has shown, this integrated approach provides a fruitful avenue to analyse policymaking processes in global financial governance.

The feedback loop between market structures and governance patterns can be explained as follows. First of all, a certain market structure creates preferences of both public and private actors for (adjustments to) a governance pattern. These preferences feed into the policymaking process (as described above). As a result of this process, a new pattern of governance emerges. The shifts in governance this entails lead to a new structure of incentives for market actors (new terms of competition). By responding to these incentives in market interaction, a new market structure forms. This brings us full circle to the creation of new preferences regarding the governance pattern that follow from this (changed) market structure. Markets and governance patterns thus evolve symbiotically, not in separate domains.

The following two subsections recap how the findings of the two case studies pan out in this theoretical model. The third subsection provides an overarching viewpoint of these two case studies to come to general contributions of this study.

The Basel Capital Accords

The fall of the Bretton Woods pattern of governance reinforced a trend towards increasing internationalisation of banking. The terms of competition changed, with competition more and more taking place in a global setting. This was accompanied by a reduction of capital adequacy ratios. A number of banking crises in the 1970s pointed both supervisors and banks to the importance of adequate international information sharing and standards to ensure the safety and soundness of the banking system (or in terms of the private actors: the safety and soundness of market counterparts). These preferences translated into the emergence of the BCBS, as well as the Basel Concordat codifying the division of labour between home country and host country supervisors. Furthermore, both in the context of market integration in the European Community and in the BCBS, preliminary discussions took place on the decline in capital adequacy and the importance of stopping this decline. These discussions did not yet, however, lead to a new pattern of governance.

When the Latin American debt crisis threw the low capital adequacy ratios into sharp relief, the preferences of American politicians quickly adapted in favour of stricter regulation for banks. The US private sector preferred less stringent, more market-based regulation, in part because of concern for their international competitive position. A deal was struck where the preferences for a safe and sound banking sector (which could according to theory be accomplished by capital adequacy standards) coalesced with private actor concerns for international competitiveness. Both preferences were to be met by giving the Fed the mandate to pursue international harmonisation of capital adequacy regulation.

These US preferences fed into a policymaking process that was led by US authorities, thereby consequently ensuring that decision-making took place in US-dominated policymaking institutions. Decision-making first took place in bilateral and later in trilateral negotiations. This therefore meant the policymaking process initially excluded the expression of continental European preferences. When the negotiations moved to the policymaking institution of the BCBS, the parameters for the Basel Accord were already set. The 'yardstick' which had been established in the US-UK negotiations left only limited room for the accommodation of national idiosyncrasies of the other BCBS members.

This focus on US-dominated policymaking institutions also explains why the common yardstick to measure the solution against conformed to the preferences of the US domestic policymaking process: the safety and soundness of banks and the levelling of the international competitive playing field through risk-weighted capital standards. This yardstick was basically informed by domestic politics in the US, and because of the dominance of the US in the initial policymaking institutions it remained the yardstick in subsequent negotiations. European countries were consequently left with little room to propose a different bank capital adequacy regime or, in other words, to express strongly divergent preferences from this group norm.

The interaction between these public and private actor preferences, ideas and policymaking institutions explains why the final 1988 Basel I Accord focused on the two goals of safety and soundness of banks and levelling the international competitive playing field. The governance pattern as established under Basel I was a shift upwards on the jurisdictional dimension, as it brought the members of the G10 together under a harmonised capital adequacy standard. The nature of the Basel I governance pattern was public. Its implementation was to be achieved by national level, public bank supervisors with little room for private sector self-regulation or input. On the third dimension, Basel I was relatively stringent for banks. Its crude risk categories were not conform banks' regular economic activities and risk management.

Basel I had a significant impact on the market structure, as it gave banks the incentive to engage in regulatory arbitrage through off-balance sheet activities like securitisation. What's more, the levelling of the playing field encouraged consolidation in the banking sector and further internationalisation. At the same time, larger banks were better equipped to 'game the system' through the complex risk management systems they developed. They could deploy competitive resources in new ways, leading to advantageous terms of competition.

This changing market structure led to a simultaneous change in actor preferences with respect to the pattern of governance. The large, internationally active banks increasingly expressed a preference for using their own internal risk models, which would lead to better risk management than under Basel I. They used influential reports by global level interest associations such as the IIF and think tanks like the G30 to develop an international consensus surrounding this more risk-sensitive approach on the policymaking agenda. Supervisors maintained their preference for a safe and sound banking system but realised banks were 'gaming the system' and circumventing the safeguards of Basel I. The BCBS emerged as the policymaking institution in which these shifting preferences coalesced (for example witnessed by the landmark study into regulatory arbitrage conducted by its secretariat). This combination of shifting preferences, emerging consensus on a new yardstick (market-based capital standards, i.e. the use of internal models) and a policymaking institution where the most important global level actors came together led to a renegotiation of Basel I.

The fact that the policymaking process took place in the BCBS as the policymaking institution led to the marginalisation of voices from outside the circle of expert financial policymakers, both in domestic politics (e.g. between ministries of finance/central banks and national parliaments and ministries of social affairs) and in the international policymaking process (other stakeholders than the financial sector itself). The discussions in this global-level policy community drew on a limited range of arguments (skewed argument pool) with a strong voice for representatives of large internationalised banks. This is also evident from the consultative papers process that was managed by the BCBS secretariat. Although seemingly offering an open and transparent policymaking process, in fact the responses to the consultative papers were heavily skewed towards private sector preferences (over 60% of responses) with less than 15% of responses coming from actors outside of the policy community of financial experts. Only incidentally did other stakeholders manage to assert their preferences, as we saw with Schröder's intervention on behalf of the *Mittelstand*.

The common outlook on the way forward that had emerged fairly quickly (the use of internal risk models to set capital adequacy standards) did not mean the public sector just gave in to private sector demands. The agenda and outcome was a genuine shared effort. On the basis of the intellectual arguments for a market-based approach – based on a narrow range of economic theory – the public actors set the goal of introducing a comprehensive risk approach. In practice, this meant for example that the public actors pushed for an operational risk capital requirement in Basel II, despite the opposition of private banks.

As with the negotiations on Basel I, it is the interaction between these specific preferences, ideas and policymaking institutions as described above that serves to explain the resultant shifts in governance from this policymaking process. These shifts had a strong bias towards the preferences of large, internationalised banks. First of all, Basel II signified a shift upward on the jurisdictional dimension to the global level. Already during the negotiations many non-G10 countries signalled their intention to implement Basel II and a special working group was established to aid in global implementation. On the second dimension of the 'nature of governance', Basel II shows a shift towards a more private nature of governance. The implementation of bank capital adequacy standards became a mixed responsibility of private actors (which run the models) and public supervisors (which check the outcomes), compared to the public implementation of the Basel I risk-weighted capital requirements. Furthermore, the ties between supervisors and banks are institutionalised under Basel II: it calls for continuous dialogue between banks and supervisors under pillar two. On the third dimension, a clear shift towards more leeway for banks is visible. Especially for banks applying the Advanced IRB approach, Basel II was less stringent.

To summarise the feedback loop in the case of bank capital adequacy standards: shifting patterns of governance under Basel I changed the constraints actors faced in their competitive interaction in the increasingly global banking system, in turn leading to changing market structures. These changes in market structures also led to adaptation of preferences for governance of both public and private actors and led to a renegotiation of Basel I to Basel II. The negotiations on Basel II took place in a global-level policy community that exhibits characteristics of groupthink and has a strong influence of large internationalised banks. This resulted in a less stringent, global-level approach to bank capital adequacy standards, oriented towards market practices of the large internationalised banks.

Governing sovereign debt crisis resolution

In the case study of the governance of sovereign debt crisis resolution, the fall of Bretton Woods led to changing terms of competition with respect to the market for sovereign debt. It allowed states to source their funding internationally, while on the supply side it allowed banks to recycle petrodollars. Increasingly, this meant sovereign credit to emerging markets was provided by syndicates of banks. The Latin American debt crisis brought to the fore this change in market structure that had occurred during the 1970s and led to an adjustment of the preferences for governance by mainly the creditor states. The creditor states realised that instead of having 'just' their own money on the line in the negotiations (as was the case in Paris Club negotiations) now the soundness of their domestic banking system was at stake. This shifted the balance in favour of official (IMF) refinancing of debtors in order to allow bank loans to be paid and the domestic banking system to recover. However, the public sector had not yet thought this new situation through, and the private sector was not quite ready to clearly articulate coherent preferences for governance patterns. The crisis was treated as a one-off event, resulting in an ad hoc resolution of the Latin American debt crisis under the Baker and Brady plans.

The governance pattern as established under the Baker and Brady plans could be seen as a shift upwards on the jurisdictional dimension as the plans set rules guiding the sovereign debt restructuring of the emerging markets in crisis (the 17 highly indebted countries, HD17). What's more, banks affected by the governance pattern were spread all over the Western world. On the other hand, both plans were aimed at the crisis-ridden countries and their creditors only; the pattern is consequently more international than global. The nature of the governance pattern was public, developed by public authorities and implemented within the context of the IMF. For market participants, the plans were quite stringent, as they stipulated the parameters under which debt restructuring would occur. However, the plans were most stringent for debtor countries, which had to implement conditionality and had to shoulder the biggest burden of the crisis resolution. Finally, it should be noted that both plans were 'temporary' governance patterns in the sense that they were an ad hoc response to the Latin American debt crisis and as such they entailed a governance pattern that 'disappeared' after that crisis was resolved.

Especially the Brady plan had a significant impact on the market structure, as it enabled the formation of a bond market for sovereign debts. By underwriting the securitisation of emerging market debts, creditor countries gave a strong incentive to the capital markets to provide emerging market finance. Banks at the same time were provided with an incentive through the Basel Accord to function as intermediaries rather than providing direct lending. Debtor countries seized this opportunity for new sources of financing and the share of bond debt in total sovereign debt increased rapidly. In terms of market structure, a substitute for bank financing of sovereign debt had been found in the form of capital market financing (although it likely represented a cross-sector integration in the financial system first and foremost, as banks were still heavily involved in the market for sovereign credit).

Public supervisors, notably the IMF, were quick to recognise the new coordination problems that would emerge from this new market structure according to economic theory and proposed a new pattern of governance in the form of an 'International Debt Adjustment Facility for Sovereign Debtors'. With the 1994-1995 Mexican crisis, the theory also became practice: the difficulty of resolving sovereign debt crises and the overwhelming amounts of official refinancing needed to rescue countries suddenly became clear to creditor countries. This led to a preference adjustment towards building mechanisms to deal with sovereign debt crises. Private creditors, on the other hand, favoured being left to their own devices in dealing with a debtor country in distress and negotiate a restructuring instead.

Discussions on this issue got another push with the 1997-1998 East Asian financial crisis and focused on the IMFC and G10 as the main policymaking institutions. The preferences of creditor states were consequently strongly represented and, as it turned out, the global private sector associations also had privileged access to the policymaking process. Public officials' preferences for a comprehensive, institutionalised solution in the form of an SDRM therefore clashed with private sector preferences for a market-based case-by-case approach.

As with the solution of the Latin American debt crisis, it is the interaction between these specific preferences, ideas and policymaking institutions as described above that explains the shifts in governance that resulted from this policymaking process, as well as the fact that a permanent governance pattern was now put in place. The shifts in governance were biased towards the interests of large internationalised banks, but it should be noted that the fact that a shift occurred at all was the result of public actor agency. The resulting pattern of governance in the form of CACs plus the Principles signified a shift upward on the jurisdictional dimension to the global level. A governance pattern applying to external debt of all countries was in place. On the second dimension of 'nature of governance', the CACs and Principles signified a shift towards more private types of governance compared to the Baker and Brady plans. It should be noted, however, that compared to the virtual absence of governance as per the early 1990s, it is more difficult to argue what kind of shifts occurred on this dimension. On the third dimension, a clear shift towards more leeway for banks can be discerned. Compared to the Baker and Brady plan setting the parameters for negotiation, and the SDRM possibly even enforcing these parameters, the CACs and Principles leave it up to the private sector and the debtor states to agree on the negotiations process as well as to come to a rescheduling agreement. This offers the private sector more room for manoeuver.

To summarise the feedback loop in the case of sovereign debt crisis resolution: shifting patterns of governance under the Brady plan changed the terms of competition in the market for sovereign credit, in turn leading to a changing market structure (in the form of capital market financing of emerging markets). These changes in market structures also led to adaptation of preferences for governance of specifically public actors and led to the emergence of new proposals for a governance pattern for sovereign debts. The negotiations on these proposals took place in a global level policy community, leading to a strong influence of large internationalised banks on the new governance pattern. This resulted in the defeat of governance proposals which would be more stringent on private actors and of a more public nature in favour of market-based patterns of governance.

Combining the findings in the two policy domains

Both case studies offer opportunities to come to more general conclusions as similar trends and dynamics are visible across them. First of all, to reiterate the point one last time, both cases exhibit a feedback loop from market structure to governance pattern that was proposed in the second chapter. In other words, there is a symbiotic relationship between shifting patterns of governance and changes in market structure. In the bank capital adequacy case, Basel I contributed to the emergence of diversified and international banks with advanced risk management practices, shifting their preferences for governance towards the use of in-house risk models. Public actors adjusted their preferences as they realised that this new market structure allowed for the 'gaming' of Basel I with the associated increases in risks. In the case of sovereign debt crisis resolution, the Brady plan encouraged capital market financing of emerging markets. This diversified the preferences of private actors and led to a reduced sense of urgency to make progress on this issue. At the same time, public actors (specifically the IMF) acknowledged the potential risks and therefore proposed a comprehensive approach. In both cases, the push for renegotiation of the current governance pattern was fuelled by the costs associated with changes in the market structure.

This account of the dynamics of global financial governance contradicts the stability predicted by Historical Institutionalism and New Institutional Economics. Allowing 'exogenous shocks' like financial crises to serve as an ad hoc explanatory factor does not solve these explanatory weaknesses of HI and NIE. The shifting patterns of governance were not primarily a response to financial crises. Although crises play an important role as intermediate causes in the sense that they highlight changes in market structure that lead to readjusted preferences, the terms of competition (reflected in changes in market structure) are central. This is shown by the renegotiation of Basel I, which was not a response to a contemporary banking crisis.

A second conclusion concerns the explanation of the dynamics of both policymaking processes. This study has shown that the outcome can be explained first of all by the constraining effects the emergence of the IMFC and BCBS as the dominant policymaking institutions had on the expression of preferences. Both the IMFC and the BCBS were skewed towards a select set of public creditor state officials (of ministries of finance and central banks) and representatives of large internationalised financial institutions. This largely excluded the expression of preferences of other stakeholders (such as organised labour). This exclusionary group exhibited the characteristics of groupthink, leading to a common yardstick to measure governance proposals against that focused on the efficient functioning of financial markets and solving market failures.

Within this already skewed argument pool, the outcome of the policymaking process reflects the contradiction between the intellectually rigorous solutions of public sector representatives (a comprehensive risk model in the case of bank capital adequacy and an SDRM in the case of sovereign debt crisis resolution) and the preferences of the private sector to maximise their leeway under the emerging governance pattern (and thus for less stringency). In both cases, this led to market-based patterns of governance that were not solely a reflection of private sector preferences (e.g. the global public standard for CACs and the inclusion of operational risk in Basel II).

A world in turmoil: the 2007 financial crisis

As mentioned, the current financial crisis begs the questions as to whether global financial governance will witness a watershed and whether the findings on banking supervision and sovereign debt restructurings of this thesis have become obsolete. For now, this is apparently not the case. The current crisis has underscored the importance of the two policy domains taken as case studies in this thesis in the global financial system. Arguably, the response of policymakers to the crisis has focused precisely on these two policy domains. First of all a renegotiation of Basel II – which was not even fully implemented– has taken place resulting in a much-touted Basel III. Second, in response to sovereign debt stress in the Eurozone's periphery, a new debate has emerged on the proper way of governing these crises (especially in the context of monetary unions). In the following two subsections, the recent developments in the policy domains of the two case studies are briefly discussed, as well as the implications for the core arguments of this thesis. The discussion is primarily based on an analysis of *Financial Times* coverage up till April 2011 of the two policy domains.

Third time lucky? The negotiation of Basel III

An important trigger of the current crisis was the failure of securitised subprime mortgages in the US. As has been demonstrated, Basel I already gave banks the incentive for off-balance sheet activities, and this incentive remained under Basel II. To a certain extent, the anticipation of the implementation of Basel II can be credited with the change in market structure that the growth of securitised assets implied.

Basel II relied on ratings to determine the risk weights of assets (either internal ratings or ratings provided by the main credit rating agencies). As it turned out, however, the reliance on ratings to adequately assess risks in the system was unjustified. The high rating of (tranches of) securitised assets proved to be overoptimistic. This implied that the risk-weighting under Basel II was too low and the capital requirement was insufficient. In general, Basel II failed to understand adequately the risks stemming from complex financial products and securitisation.[1] Furthermore, the Basel II models failed to capture systemic risks that emerged over the course of the crisis (like the liquidity freeze in the interbank market). Many banks experienced liquidity problems and large amounts of direct state support and/or wider liquidity injections by central banks were needed to ensure the soundness of the global banking system. The skewed argument pool in the BCBS (biased towards the preferences of large international banks) had led to a misguided focus on market-based risk management.[2]

As noted above, the crisis reflected the change in market structure in the banking sector towards a cross-sector and internationally integrated banking market with an originate-to-sell business model of individual banks. The radical reordering of the market that the acute phase of the crisis implied led to a realignment of preferences of the actors involved. More importantly, it unsettled the balance of power among the different actors. Public opinion turned against the banks, which appeared to have profited handsomely from engineering this huge crisis and were now being bailed out by taxpayer money. This put political pressure on public supervisors for more stringent regulation. Supervisors themselves (not to mention banks) were also confronted with apparent flaws in the Basel II approach and the need to provide huge amounts of capital to make up for the shortfall in private institutions. Supervisors that had never been too enthusiastic about the model-based approach of Basel II – such as the Swiss - felt vindicated and saw an opportunity to break through the groupthink. The large international banks, the main voice of opposition to stringent regulation, were seemingly 'on the ropes'. These shifting preferences and balance of power prepared the ground for a new round in the policymaking process.

In the autumn of 2007, discussions mainly focused on liquidity risks, which were not (yet) addressed under Basel II. This was an issue that had already been on the BCBS' radar, and got an impetus from the credit crunch. However, some supervisors also started calling for higher capital requirements for off-balance sheet items.[3] This was all still within the framework of Basel II, which would not come into force until January 2008 in many countries. The IIF pleaded to avoid a knee-jerk reaction from supervisors. Regulators should take the back

[1] DNB, 2009, p. 30.
[2] As had already been pointed out by Persaud, 2000 and Daníelsson, et al., 2001.
[3] E.g. the Governor of the Bank of Canada, David Dodge (Financial Times, 14 September 2007) and the Chairman of the UK FSA, Callum McCarthy (Financial Times, 22 October 2007).

seat while an IIF Special Committee on the Crisis would examine which response was needed. They were especially eager to avoid blanket capital increases, instead focusing on specific elements of the crisis that warranted modifications in Basel II (such as liquidity risk).[4]

As the crisis dragged on, in early 2008 Germany joined the push for higher capital requirements and a more stringent application of Basel II (although explicitly not asking for Basel III). Germany's Finance Minister, made it clear that if this could not be achieved at the global or European level, Germany would go it alone.[5] The fact that a number of German banks were caught up in the turmoil of the crisis (including IKB that required a new capital injection) no doubt contributed to this position. International momentum for more stringent capital requirements built up further when the interim report of the FSF to the G7 meeting of 9 February 2008 in Tokyo mentioned that the minimum requirements under Basel II might need to be revised.[6] Finally, in March 2008, US Secretary of the Treasury Hank Paulson joined the fray while outlining the US administration's response to the crisis: Basel II had to be revisited with respect to off-balance sheet exposures and liquidity risks.[7] This change of heart seems quite logical in light of Bear Stearns' collapse in the same month.

It was clear, however, that the underlying philosophy of Basel II was not challenged by the supervisors. The models were to be adjusted to capture the risks they had not adequately captured in advance of the crisis. Nout Wellink (president of De Nederlandsche Bank and chairman of the BCBS) argued on the eve of the IMF Spring Meetings of 2008 that Basel II was sorely needed in these times.[8] He was joined by former Federal Reserve President Alan Greenspan, who mounted a defence of the Basel II approach.[9]

During the IMF Spring Meetings the G7 ministers of finance and central bank governors had their regular meeting, and a second, special meeting with international bankers. The meeting with bankers led to irritation on the part of the public officials for the lack of accountability of the private sector: the private sector accepted some responsibility for the crisis, but at the same time pleaded for a self-regulatory approach.[10] This did not go down well with the G7 public officials, and it was decided that Basel II was to be modified on a number of issues. These issues corresponded to the changes in the market structure that the crisis had painfully exposed (e.g. the liquidity risk stemming from the increasing international integration of banking).

The BCBS responded swiftly, and published its first proposals only days after the IMF Spring Meeting.[11] Realising the inevitable, the IIF signalled it "looked forward to discuss the BCBS proposals – mindful of the need for adjustment to requirements to be proportionate to actual risks – and underscored that these changes had to be implemented prudently, over time."[12]

The Swiss went even further and decided to impose a leverage ratio in the summer of 2008.[13] This seemed quite timely, as the October 2008 collapse of the Icelandic banking system (followed by the collapse of Iceland itself) put the spotlight on small countries with large banking systems relative to GDP. It also put pressure on the BCBS to open up the discussions on the revision of Basel II to new approaches to address risks.

In September 2008, the BCBS published its proposals on the inclusion of liquidity risk in the Basel framework.[14] The autumn of 2008, however, was dominated by the collapse of Lehman Brothers in September and the subsequent near meltdown of the global financial system. This led the newly appointed UK FSA Chairperson (Lord Turner) to call for a 'clean slate' with respect to capital adequacy standards in response to the crisis.[15]

In January 2009, the BCBS published a consultative paper outlining its proposed 'enhancements' to Basel II.[16] These included, for example, the liquidity risk provisions published earlier. Other important topics in these enhancements were a better modelling of the risks of securitisation, a stricter definition of what may count as capital for banks, the obligation for banks to raise capital buffers when times are good and higher capital adequacy requirements for systemically important banks. In addition, a second, simpler measure for capital adequacy was discussed: a gearing ratio (also known as a leverage ratio, a ratio of capital to balance sheet total). The Swiss initiative had paid off.

Banks, in the meantime, came under increasing pressure from markets to increase their capital (as a result of pillar three of Basel II). This also led to changing preferences among prominent bankers. Josef Ackermann, chief executive of Deutsche Bank and a high-profile IIF figure, acknowledged that 'fundamental methodological adjustments' to Basel II were necessary. He supported the idea of cyclically adjusted capital requirements.[17] These comments were echoed by Stephen Green, chief executive of HSBC.[18] As a further sign of reduced opposition by the private sector to more stringent capital requirements, attention of bankers' associations now focused on slowing down the implementation of more stringent requirements. The British Bankers Association, for example, warned regulators that implementing tougher requirements too fast could force banks to reduce lending, and thus contribute to a double dip recession.[19]

4 Financial Times, 22 October 2007.
5 Financial Times, 6 February 2008.
6 FSF, 5 February 2008.
7 Financial Times, 14 March 2008.
8 Wellink, 10 April 2008.
9 Greenspan, 17 March 2008.
10 Financial Times, 14 April 2008.
11 Financial Times, 17 April 2008.
12 Dallara, 13 May 2008.
13 Financial Times, 27 June 2008.
14 BCBS, September 2008.
15 Financial Times, 17 October 2008.
16 BCBS, January 2009.
17 Financial Times, 20 March 2009.
18 Financial Times, 26 March 2009.
19 Financial Times, 29 June 2009.

The crisis also had important implications for the main policymaking institutions for bank capital adequacy standards. Reflecting the rise in prominence of the G20 as the apex forum for global finance (and the rise in prominence of emerging markets in general), it was announced in June 2009 that the membership of the BCBS would be extended to all G20 members.[20] However, as with the BCBS negotiations on Basel II, the yardstick with respect to the emerging Basel III was already set by then. It can be doubted, therefore, that the preferences of the new BCBS members had a significant impact on the final Basel III Accord.

Soon after this extension of membership, in September 2009, the BCBS reached broad agreement on the revised Basel Accord (by now called the Basel III Capital Accord). Both capital quality and the overall level of capital would be increased and a leverage ratio would be added. It was agreed that the BCBS would make concrete proposals by the end of 2009, which could be finalised after quantitative impact studies in 2010. It was expected that the new Accord would force banks to raise significant amounts of capital.[21] On the other hand, supervisors took on board bankers' warnings for an adverse effect on economic recovery. It was pointed out that the tougher rules would only come into force once recovery was assured.[22]

In December 2009, the BCBS duly laid out a 'tougher than expected' Basel III. 'Hybrid capital' as part of tier one capital would be phased out, a leverage ratio was added, as well as a liquidity requirement that would cover a 30-day market crisis. The standards furthermore included a cyclically adjusted capital ratio, and suggested that banks would be banned from paying bonuses and dividends if capital ratios fell to low. The BCBS noted that it "will put in place appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition to the new standards."[23] This reflected bankers' opposition to a swift phase-in.

However, differences between various BCBS supervisors began to show. Some states had made more progress in cleaning up banks' balance sheets than others. Moreover, the use of hybrid capital was more prevalent in some countries than in others. The phasing out of hybrid capital thus proved contentious, with on the one hand the US, UK and Switzerland (which were in favour of tougher capital rules), and on the other hand Germany, France and Japan which were resentful because this measure was specifically punitive for their home country banks. The latter group was also not in favour of a strict leverage ratio.[24] During a June 2010 deputies G20 meeting in Busan, South Korea it became clear the rift between the two blocs could not yet be overcome. The UK and US offered a slower phase-in of Basel III in return for no tinkering with its stringency. French and German resistance was persistent, however, and focused on the inclusion of some forms of hybrid capital in tier one.[25]

[20] BCBS, 10 June 2009.
[21] Financial Times, 8 September 2009.
[22] Financial Times, 6 October 2009.
[23] Financial Times, 18 December 2009.
[24] Financial Times, 26 April 2010.
[25] Financial Times, 5 June 2010.

The international banking lobby pushed for an even slower phase-in of Basel III than envisaged by the BCBS. Cunningly, they pointed to demands by politicians that banks must contribute to funding the economic recovery and claimed they would not be able to do this under an 'excessive' Basel III capital requirement.[26] The IIF published a high-profile report arguing against a more stringent Basel III in June 2010. This widely reported study claimed that the costs of stringent regulation would be significant. Economic growth would be cut by three percentage points between 2010 and 2015, and as a result 9.7 million fewer jobs would be created. Conveniently, the analysis of the IIF did not take the costs of bailing out banks into account in their cost/benefit analysis.[27] The bankers' lobby's claim of an adverse economic impact was supported by the French and German business confederations, which complained that Basel III would reduce credit availability.[28]

The opposition of the private sector (both by bankers and the industry) was successful in paring down the most controversial proposals of Basel III. This was apparently also driven by the desire of supervisors to ensure they made the deadline of the November G20 summit in Seoul.[29] It seems, however, that every step back by the supervisors was not so much a step towards a compromise with the private sector, but rather an invitation for bankers to step up the pressure and further oppose certain features of Basel III. This led Sheila Bair, chairperson of the FDIC, to complain that supervisors were 'succumbing to disingenuous lobbying.'[30]

On 26 July, a breakthrough was achieved. All but one of the 27 BCBS members agreed to a new draft of Basel III (Germany postponed a final decision until the Seoul summit). The revised proposals appeased the bankers' lobby in several ways. For example, the leverage ratio (3 per cent of unweighted assets) would only be 'tested' until 2017, while the exact new capital requirement was still to be determined. Nevertheless, bank share prices jumped in response.[31] Supervisors, on the other hand, claimed that the toning down occurred because of the deteriorating economic outlook (the sovereign debt crises in the Eurozone periphery and the weak US recovery). Moreover, the pressure that the development of Basel III was under (the Seoul summit deadline) led supervisors to settle for toning down controversial elements of the Accord.[32]

In August 2010, the BCBS reported its own assessment of the economic impact of the new Basel III Accord.[33] Whether due to the toning down of the Accord or due to better measurement methods (or perhaps due to a less self-interested analysis), the predicted economic impact of the new Accord was significantly lower than that predicted by the aforementioned

[26] Financial Times, 12 April 2010.
[27] IIF, June 2010.
[28] Financial Times, 15 June 2010.
[29] Financial Times, 25 June 2010.
[30] Financial Times, 21 July 2010.
[31] Financial Times, 27 July 2010.
[32] Financial Times, 19 Augustus 2010. Apparently supervisors used the 'if in doubt, cut it out' rule to speed up the process.
[33] BCBS, August 2010.

IIF study. Each additional percentage point capital requirement would reduce annual economic growth by only 0.04 per cent over its implementation period. This surely helped public supervisors overcome their concerns with respect to the impact on the economic recovery.

In the period running up to the BCBS governors' meeting that was supposed to put the finishing touches on the Accord, German banks made a last-ditch effort to further water down the Basel III standard. Both the Bundesverband Deutscher Banken and the Bundesverband Öffentlicher Banken Deutschlands (respectively the private and public sector bank associations) warned of the negative effects the current Basel III would have on the German economy. Especially the publicly owned banks made much use of hybrid forms of capital that would no longer be counted towards tier one under Basel III.[34] Several other financial actors also warned that the liquidity provisions in the draft could seriously hamper corporate credit.[35]

Notwithstanding the German opposition, the governors of the BCBS agreed to Basel III on 12 September 2010 (perhaps encouraged by the relatively mild effects according to the BCBS' quantitative impact study). The new Accord included an effective tier one capital requirement of 7 per cent of risk-weighted assets. Falling below 7 per cent would lead to restrictions on bonuses and dividends, with 4.5 per cent being the absolute minimum. The transition period to the new regime would last six years to 2018. In addition to this tier one ratio, a number of buffers were considered to deal with, for example, the economic cycle. In general, bankers reacted with relief. Most large international banks did not foresee too much trouble reaching the targets.[36] The agreement of the BCBS was formalised by the G20 summit in Seoul on 11-12 November 2010.

Several supervisors had already hinted that they consider imposing stricter rules than the Basel III Accord. The Swiss were the first to make public additional capital requirements for big banks (UBS and Credit Suisse). The UK seemed intent on following suit (which would be consistent with both country's history of topping up the Basel rules with a 'Swiss finish' or 'gold-plating').[37] The Swiss move was in line with a more general discussion on additional capital requirements for systemically important institutions, which is still ongoing at the time of writing.

This brief summary of the negotiations on a new pattern of governance for bank capital adequacy (which are still ongoing at the time of writing) shows how the changes in market structure that were so mercilessly highlighted by the crisis led to adjustments of actors' preferences. This was specifically the case for bank supervisors of the BCBS, but also for the (few) banks that remained purely private market actors as they were pressurised by market forces to increase capital adequacy. After Basel I and II had encouraged off-balance sheet activities and international integration, Basel III tried to mitigate some of the resulting risks. However, with

34 Financial Times, 7 September 2010.
35 Financial Times, 10 September 2010.
36 Financial Times, 13 September 2010.
37 Financial Times, 8 October 2010.

the BCBS still the main policymaking institution (although augmented by G20 supervisors halfway through the process), the general philosophy of Basel II flowed over into Basel III. This is not surprising when you consider that the BCBS had spent years building a consensus on the superiority of a market-based approach in a process of groupthink and skewed argument pools. The question as to whether the approach itself was potentially flawed and/or a cause of the crisis was not posed.

The process also shows how the need for bailouts of banks revived the close ties between bank supervisors and their domestic financial system. Especially Germany fought to protect the interests of its own banks in counting 'hybrid' capital under tier one in Basel III. This also shows how state actors simultaneously think of the terms of competition and the policymaking process: it was the public sector banks (Landesbanken) who would be most negatively affected by the exclusion of hybrid capital.

It could be noted, that just as Basel I gave an incentive for sovereign lending to OECD countries, so does Basel III provide an incentive to sovereign lending to G10 states. This incentive results from the need to build more capital, and also from the higher risk-weighted capital requirements on many other categories of lending. This certainly was not unwelcome news for G10 governments which have large funding requirements due to crisis-related expenses.

Sovereign debt crises coming home to roost: the response to sovereign debt crises in the Eurozone periphery

After the financial sector was brought back from the brink through massive state intervention, market actors turned around and bit the hand that fed them. The economic slowdown caused by the financial crisis put the sovereign debt dynamics of a number of states in doubt (as reflected in market spreads and EU/IMF rescue packages), especially states in the Eurozone's periphery. These were soon derogatorily called PIGS (Portugal, Ireland/Italy, Greece and Spain). This has led policymakers to realise once again that 'governance light' still prevails for the orderly resolution of sovereign debts in the case of a monetary union. Whatever the specific cause of the Eurozone's periphery's problems,[38] the question now is not who to blame but how to solve the problem. The governance pattern for sovereign debt crises is consequently back on the agenda, which is all the more reason why it is important to understand what happened during previous phases in the policymaking process.

The outlook for the sovereign debt market initially improved with the crisis, as the credit crunch led to a 'flight to quality'. However, friction in the Eurozone started to show already in early 2008 when spreads between different Eurozone bonds started to diverge. Over the course of 2008, Credit Default Swap spreads on many Western countries rose, as these countries increased their public debts through bank rescues and stimulus packages. Again, the divergence in spreads in the Eurozone also grew. The collapse of Iceland in October 2008 put

38 See Jones, 2009a, for an analysis debunking some of the popular causes.

the issue of sovereign debt dynamics front and centre, and did not improve spreads.[39]

Strains in sovereign funding in the Eurozone increasingly began to show, with the US and Japan benefiting from the flight to quality. Even Germany had a close call raising funds, while S&P downgraded Greece from A to A- and put Portugal and Spain on the watch list.[40] This led the Centre for European Policy Studies to call for the establishment of a 'European Financial Stability Fund' that would offer Eurobonds to satisfy the demand for solid European bonds.[41] This idea was backed by George Soros, but readily dismissed by Germany.[42] The ECB went even further and reminded states of the 'no bailout' clause of the Treaty of Lisbon (after Germany apparently considered ways to help debtor countries in trouble).[43]

As the credit crunch wore on over the course of 2009, the situation in Greece deteriorated (rising budget deficits and spreads). The EU stepped up political pressure on the Greeks to adhere to domestic adjustment to stave off a potential crisis.[44] Notwithstanding, in early December, Greece was further downgraded by Fitch to BBB+. Although Germany had earlier indicated it would not let a Eurozone country go bankrupt, it now indicated Greece had to find its own way out of the crisis. The Greeks increasingly desperately tried to do this, apparently by requesting sovereign funding from China through a deal with Goldman Sachs (a deal that was denied by the authorities).[45]

Pressured by the European Commission, 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, and did not include any official refinancing. Domestic adjustment was still thought to be sufficient to deal with the unfolding Greek drama. Private actors in the meantime increasingly turned their eye to Spain and Portugal as well and drove up their funding costs.

On 4 March, ahead of meetings of the Greek Prime Minister Papandreou with Merkel and Sarkozy, Greece threw the towel into the ring and announced it was prepared to seek IMF assistance if European support was not forthcoming.[46] European leaders were still very hesitant to pledge official refinancing, which caused the situation in Greece to deteriorate even further.[47] After a feverish weekend of negotiations, the Eurozone finance ministers announced the EU stood ready with an emergency financial support facility based on direct bilateral loans to Greece (while denying Greece needed immediate help, however). Details of the plans (and amounts) were not revealed yet.[48]

39 Financial Times, 10 October 2008.
40 Financial Times, 11 December 2008 and 15 January 2009.
41 Gros & Micossi, 30 October 2008.
42 Financial Times, 26 February 2009.
43 Financial Times, 21 February 2009.
44 Financial Times, 30 November 2009.
45 Financial Times, 28 January 2010.
46 Financial Times, 4 March 2010.
47 Financial Times, 6 March 2010.
48 Financial Times, 16 March 2010.

The details became clear after a Franco-German summit, at which Sarkozy and Merkel agreed on the terms of the financial assistance. The IMF would be involved (a German demand), and a decision to provide assistance would have to be unanimous (providing Germany with a veto). Furthermore, next to the IMF surveillance of the conditionality, the ECB and European Commission would also make assessments of adherence to the conditionality. The European agreement was specifically targeted at Greece, and in that sense did not entail durable shifts in governance.[49] The immediate response to the sovereign debt crisis in Greece was thus quite similar to previous episodes of crisis discussed in chapter five: official loan-based refinancing and domestic adjustment.

The agreement did not lead to an improvement in Greece's market position, yields continued to increase and its credit rating was further downgraded. During a lengthy teleconference initiated by Sarkozy on Sunday, 11 April, EU leaders agreed on a statement to provide the details of the rescue package. Merkel's initial demand of 'unsubsidised' interest rates went unheeded, with France aiming for a rate of the second-highest Eurozone borrower (4.5 per cent for Ireland and Portugal). In the end, a total of € 30 billion would be provided by the Eurozone at a 5.3 per cent interest rate (against the 7 per cent prevailing market rate).[50]

Despite market pressure on Greece increasing (e.g. further downgrades), the Greeks resisted for a couple of weeks (allowing the sovereign debt crisis to intensify and spill over to other Eurozone countries). At the G7 meeting in advance of the IMF Spring Meeting (22 April 2010), the US and others pushed the Eurozone to take decisive action. It was clear the combined EU/IMF rescue package of € 45 billion promised earlier to Greece did not go far enough. The G7 agreed that urgent and collective action was necessary. Later that weekend, an € 110 billion rescue package was unveiled. It consisted of € 80 billion of Eurozone loans and a € 30 billion IMF programme.[51] In return for the loans, the austerity package of Greece was beefed up even further (e.g. cuts in public sector salaries and pensions, a rise in value added tax and increases in alcohol, fuel and tobacco taxes).[52]

The rescue package did spur a debate on how to resolve sovereign debt crises. The Brussels-based think tank Bruegel called for a European variant of the SDRM.[53] This did not gain traction in the policymaking process, however. More support existed for the idea of a European Monetary Fund, which was supported by Germany, the European Commission and the socialist faction in the European Parliament.[54] However, preliminary proposals concerning 'crisis resolution' of the Commission that were leaked in May only mentioned that countries should be willing to support a country in trouble.[55]

49 Financial Times, 26 March 2010.
50 Financial Times, 15 April 2010.
51 Financial Times, 11 October 2010.
52 Financial Times, 3 May 2010.
53 Pisani-Ferry & Sapir, 29 April 2010.
54 Financial Times, 30 April 2010.
55 Financial Times, 1 May 2010.

The € 110 billion rescue package did not have the effect of improving the situation in the Eurozone, rather the opposite. Pressure on Portugal and Spain increased and the sovereign debt crisis appeared to be spiralling out of control. To quell the market unrest, the Eurozone leaders, during a tense summit in the weekend of 8-9 May, committed to a € 500 billion emergency facility (€ 440 billion of debt guarantees, € 60 billion of actual balance of payments support) augmented by a € 220 billion IMF commitment. This proposal resembled the aforementioned European Monetary Fund, which would provide official financing accompanied by tough domestic adjustment in case of sovereign debt crises. It also led to a shift in governance to the regional level, or perhaps better put, a newly emerging role for the regional level (as the plan would not necessarily lead to significant shifts away from the IMF).[56] The facility would run for three years.

Although the facility seems a European solution, during the weekend President Obama contacted European leaders and a G7 conference call took place, all pushing the Europeans to get on with it. Germany was very much against a facility under the Commission's control, arguing its constitutional court would not agree to it. A breakthrough came from the Dutch, which proposed setting up what in effect amounted to an SPV.[57]

Noteworthy, the ECB also agreed to a role in the rescue efforts through the buying of sovereign bonds. Sarkozy, Berlusconi and other Southern European prime ministers had called on the ECB to do this, while Merkel, the Netherlands and Finland strongly supported the independence of the ECB. Although Trichet had, of course, considered the option, he was adamant he would not be pushed by politicians and hence would not openly commit to a bond-buying programme until the leaders had reached agreement. The eventual decision of the ECB to indeed start buying bonds caused a rare public argument in its governing council. The president of the Bundesbank, Axel Weber, publicly criticised the move. However, the ECB governing council had agreed to the bond purchases with an overwhelming majority and so the programme was implemented as planned.[58] From now on, the ECB would be an even more important player in crisis resolution discussions: not only as a prominent public actor, it now also had a role as a market actor owning large chunks of Eurozone debts.

The initial positive effect of the rescue package on market prices declined after as little as a few days. There were continuing concerns about the growth prospects of Spain and Portugal under their austerity programmes, while at the same time investors wanted proof of the countries' ability to deliver. The facility did lead to a reduction of the bond yield spreads between Germany and the PIGS. Given that most investors admitted they were not buying, it seems the narrowing of the spread was due to ECB demand.[59]

[56] Financial Times, 10 May 2010.
[57] Financial Times, 11 October 2010.
[58] Financial Times, 11 October 2010.
[59] Financial Times, 18 May 2010.

The US pushed the Europeans to proceed with their 750 billion rescue facility as a way to stop market unrest. They were unhappy with the – in their view – tardy European response. The general approach of official refinancing combined with domestic adjustment was not put into question, however.[60]

In the meantime, the facility's details were being worked out in preparation for the EU summit of 17 June. 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 would be set up for three years (at German insistence) and be headquartered in Luxembourg. European leaders hoped their guarantees would be enough for a triple A rating, which the EFSF could use to emit bonds to finance its balance of payments support. Members would have to negotiate a memorandum of understanding with the Commission to ensure conditionality (domestic adjustment).[61] Of course, the co-financing with the IMF would also ensure domestic adjustment through IMF conditionality. In other words, official refinancing accompanied by domestic adjustment (the fiscal consolidation requirements imposed on the rescue funds) is still the combination of choice.

With the EFSF, the European banking sector's troubles had not ended. It was unclear how badly the banks would be hit by a potential default of Greece (or one of the other PIGS for that matter). At the same time, attention focused on Spain, which seemed destined to follow the same path as Greece. Eurozone governments, led by Germany, put pressure on Spain to come up with ambitious domestic adjustments. It was even leaked to the press that Spain might apply for funding from the EFSF, which did not sit well with the Spanish. Meanwhile, US Secretary of the Treasury Geithner had used a European tour to push for stress tests in the banking sector. These had worked well in the US, by clearing up the uncertainty surrounding banks' positions. Seemingly in retaliation for Germany's pressure on Spain (Germany was speculated to be the source of the rumours about Spain applying for EFSF funding), Spain unilaterally announced it would publish the results of the stress tests. Grudgingly, the other Europeans followed, with especially Germany in the limelight as the *Landesbanken* were likely to be in bad shape.[62]

Rumours began to surface in July that Germany was considering a mechanism to promote the orderly restructuring of sovereign debts.[63] Moreover, the EFSF did not stop sovereign debt problems from spreading in Europe. In response to the weak market outlook – compounded by fears of an adverse impact of the Basel II rules – the ECB stepped up its buying of bonds in early September.[64]

[60] Financial Times, 27 May 2010.
[61] Financial Times, 17 June 2010.
[62] Financial Times, 26 July 2010.
[63] Financial Times, 14 July 2010.
[64] Financial Times, 9 September 2010.

Tommaso Padoa-Schioppa, a respected financial policymaker and at the time president of the Notre Europe think tank, was the first to plead for a permanent EFSF.[65] This would mark a permanent new pattern of governance for sovereign debt crises in the Eurozone.

In October the broad contours of the German plans with respect to crisis resolution surfaced. A permanent mechanism should be set up to ensure private sector involvement in crisis resolution. In case of a sovereign debt crisis, the private sector would have to endure a haircut, although it was not yet clear how this would be enforced (the other side of the coin was that there would be a much more stringent governance pattern with respect to member states' fiscal balances).[66] The French struck a deal with Germany in which the 'preventive' side of the coin (stringency on fiscal balances) was traded for a permanent mechanism. France opposed the private sector bail-in, however. The UK indicated it was willing to consider limited amendments to provide for a permanent EFSF, although it would not agree to a transfer of power from Westminster to Brussels.[67] Smaller European states were initially mainly annoyed at this old-fashioned Franco-German power play, but eventually agreed to it. The ECB was vocal with warnings of the adverse market impact.

The response in the market to the possible private sector involvement was indeed adverse: bond yields for Ireland, Greece, Portugal and Spain rose. Interestingly, there seemed to be little outright opposition to the plans, possibly also because they were still lacking in detail.[68] In the weeks to follow, the outlook for the Eurozone's periphery economies deteriorated, especially for Ireland. This forced the Eurozone leaders at the G20 summit in Seoul on 11-12 November 2010 to issue a statement reiterating that the proposals for a governance pattern for sovereign debt crises would not apply to currently outstanding debt.[69] It also led more and more European leaders to air their resentment of the German push for a mechanism, claiming it also pushed the Eurozone to the brink of default.[70] A claim that ultimately proved to be accurate, as Ireland entered into rescue talks with the EU and IMF in late November.

However, Merkel was not to be deterred. On 29 November 2010, France and Germany reached a deal that was supported by the ECB and European Commission. The plan was developed in close cooperation with Herman van Rompuy (chairperson of the European Council) and Jean-Claude Juncker (Prime Minister of Luxembourg and chair of the Eurogroup). The EFSF would get a permanent replacement in 2013 in the form of a European Stabilisation Mechanism (ESM). 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. Where the plan in first instance saw no role for debt restructurings, the ESM did leave open the

[65] Padoa-Schioppa, 28 September 2010.
[66] Financial Times, 8 October 2010.
[67] Financial Times, 20 October 2010.
[68] Financial Times, 2 November 2010.
[69] Financial Times, 13 November 2010.
[70] Financial Times, 17 November 2010.

possibility of standstills and haircuts as a condition to further assistance if debt burdens were deemed unsustainable by IMF, ECB and the Commission. However, several officials (especially the ECB and in France) indicated the ESM's procedures in respect of sovereign debt restructurings did not differ from those of the IMF.[71]

Just days after the agreement on the ESM, Ireland was the second country to turn to the EFSF and IMF for a € 85 billion rescue programme. Furthermore, Juncker and Italy's Economy and Finance Minister Giulio Tremonti launched a plan to emit Euro-wide bonds ('E-bonds') by a European Debt Agency. This facility could, in exceptional circumstances, provide in the financing needs of countries with impaired access to debt markets.[72] As before, Germany was quick to dismiss these plans. Private actors differed in their view on the desirability of E-bonds.[73] On Thursday, 16 December 2010 the European Council approved an amendment to EU treaties to create the ESM. Officials from Germany, Finland, the Netherlands and Sweden insisted that the EU should underscore the need for domestic adjustment in the periphery. The idea of E-bonds was not adopted.[74]

The ESM deal determined the future governance pattern in the Eurozone with respect to sovereign debt crisis resolution (starting in 2013), with the EFSF functioning as the governance pattern for immediate sovereign debt problems. And problems there were plenty; the Eurozone debt crisis has continued to claim victims (Portugal) and necessitated additional rescue packages. Surprisingly, the IMF has been conspicuously absent when more structural solutions to the Eurozone's debt crisis (e.g. the return of the SDRM proposal) were being discussed in relevant policy forums (e.g. Ecofin). Many actors did return to the fore with their proposals, including professor Kenen with his International Debt Discount Corporation proposal of 1983.[75] Nevertheless, the response to the crisis resembles the response to the Latin American debt crisis: official refinancing and domestic adjustment.

The policymaking process on the Eurozone's crisis seems to mimic the global-level responses to sovereign debt crises closely, and leading to a regional version of the IMF in the form of the ESM. This can likely be explained by the fact that the process continues to be strongly informed by market opinion of the developments, and consequently conforms with the broad market-based outlook of global financial governance – also within the EU. As a result, the burden of adjustment remains at the debtor countries, and no new mechanisms for the orderly resolution of sovereign debt crisis are seriously discussed.

[71] Financial Times, 29 November 2010.
[72] Juncker & Tremonti, 6 December 2010. This suggestion had been put forward by several academics, e.g. Jones, 2010.
[73] Financial Times, 7 December 2010.
[74] Financial Times, 17 December 2010.
[75] Kenen, 11 February 2011.

The final word: new avenues for global finance in the 21st century?

In this conclusion to the conclusion, first of all the implications of the analysis for future research are examined. Furthermore, I would like to draw attention to the implications of this research for both policymakers and the broader citizenry. The findings of this study and the recent developments in the global financial system point to some important avenues for further exploration by IPE scholars, building on the analysis this thesis provides. Two avenues might prove particularly fruitful: the rise of the emerging markets in global financial governance and the emergence of private governance mechanisms.

The rise of emerging markets (especially the BRICs[76]) is, for example, reflected in the emergence of the G20 as the prime policymaking institution in global financial governance, as well as the increasing voting shares of a number of important emerging markets in the IMF. Where the emerging markets were earlier mainly the subject of policy discussions (e.g. in case of sovereign debt restructurings), the financial crisis has strengthened their role in the global policymaking process and on the global financial markets (for example reflected in the rumours about a Chinese loan to Greece). The possible consequences of this development for our understanding of global financial governance are as yet not fully understood. Shifts in global financial governance have been widely analysed in the IPE literature on multilevel governance (to which this thesis also contributes). This strand of literature focuses mostly on shifts in governance in the sense that certain policy issues are shifted upwards to the global level (e.g. the global coordination of banking supervision in the BCBS). On the other hand, the rise of the BRICs has led to a strand of literature in International Relations that focuses mostly on these states as actors in an inter-state context (examining, for example, consequences for the balance of power). A fruitful area of future research by IPE scholars could seek to fill the gap between these strands of literature through synthesising the valuable insights from both approaches. This would contribute to our understanding of what the rise of the BRICs means for global financial governance, but also what it means for the states in question and their international relations.

A second avenue for further research is offered by the emergence of private forms of governance and the role played by global private interest associations in policymaking processes. Although this thesis has pointed to the importance of the interaction between public and private actors, clearly important private forms of governance are emerging as well (the Principles for Stable Capital Flows are a case in point). Moreover, this thesis has argued that global level private interest associations play an important role in the policymaking process. Up to now, relatively little attention has been paid in the literature to these kinds of private governance arrangements.[77] Relatively little is known about the dynamics of policymaking processes consisting of mainly private sector actors, such as the negotiations leading to the Principles. Furthermore, the aggregation of private sector interests through global business associations like the IIF is often treated as a black box. I would contend that this creates the risk of seeing the private sector as a monolithic bloc, while an important part of the politics of global financial governance is actually contained in the dynamics of private sector negotiations between different types of private firms. Opening this black box of private sector policymaking processes thus offers a fruitful avenue to further our understanding of the developments in global financial governance.

Next to offering fruitful avenues for future research, this thesis also offers a host of practical recommendations for policymakers. From a normative perspective, the legitimacy of this process is central to a well-functioning global financial system.[78] Legitimacy has been famously divided into input legitimacy pertaining to the policymaking process and output legitimacy pertaining to the effectiveness of the governance pattern.[79] Elsewhere, I have argued with Underhill and Mügge that this distinction actually misses the fact that input and output legitimacy are linked.[80] As these are two sides of the same coin, we can improve the functioning of the financial system (output legitimacy) by improving the policymaking process. The prime take-away message for policymakers of this thesis should therefore be that the input legitimacy of financial policymaking must be improved. A wider range of stakeholders should be included, and it should be ensured that these stakeholders engage in substantive discussions on the trade-offs inherent in the global financial system. For example, one practical proposal to achieve this would be 'compulsory' consultations with a wider set of stakeholders.[81] This would mean that the BCBS would not only put a consultative paper on its website and wait for responses, but should actively contact CSOs (including, for example, labour unions) to solicit their responses. The process should not be allowed to continue without wide-ranging inputs and a public discussion on what the BCBS intends to do with these inputs.

Last, but certainly not least, this study offers valuable lessons for concerned citizens. As was pointed out in the introduction to this concluding chapter, the costs and benefits of global financial integration have been distributed unevenly. We should hope improved input legitimacy would lead to better outcomes for a wider public. Different polities may make different choices regarding the trade-offs in the global financial system, and these should be accepted and facilitated by the global policymaking institutions. As the metaphor coined by Underhill goes, countries should be able to 'check out of Hotel Capital Mobility.'[82]

[76] Brazil, Russia, India and China.
[77] But see Cutler et al., 1999; Higgot, Underhill & Bieler, 2000; and Fransen, forthcoming 2011.

[78] See, for example, Porter, 2001; Germain, 2001 and 2004; Underhill, Blom & Mügge, 2010. A legitimate process could also lead to an accepted definition of what 'well-functioning' would entail.
[79] Scharpf, 1999.
[80] Underhill, Blom & Mügge, 2010. This argument was introduced first in Underhill & Zhang, 2008. See also Jones, 2009b, for an interesting argument about the consequences of relying on output legitimacy in the European Economic and Monetary Union in the context of the current crisis.
[81] For more policy recommendations, see Blom, 2010 and 2011.
[82] Underhill, 2007.

But this should not mean developing global financial governance for the twenty-first century is only up to the decision-making elites. Individual citizens should have the opportunity to exit the global casino that has been built.[83] Offering a wider and more transparent choice in the often opaque financial instruments citizens are consuming would empower citizens to make their own choice for the kind of financial system they want. Do I chose a pension fund that invests in 'alternative investments' or do I chose a pension fund that excels at investing in sustainable energy? Does my bank try to offer a slightly higher interest rate through 'sophisticated' financial engineering, or does it try to invest in local communities?

By this two-pronged approach of an improved (global) policymaking process and improved opportunities for satisfying market demand of socially responsible financial products, policy space might be created to seek alternatives to the current global financial system and the unbridled expansion of market forces. Most of all, it brings us back to the prime message of this thesis that has relevance for scholars, policymakers and citizens alike: we should not think of politics or market behaviour when thinking of the shape of the global financial system in the twenty-first century, we should rather think of how an integrated understanding of politics and markets can be harnessed to develop courses of action (on markets and in politics) that promote a global financial system that serves our common future.

[83] Strange, 1986. This argument is further developed in Blom, 2011.

Annex: data sources

Interviews[1]

For this study 93 interviews have been conducted. Some of these interviews were in the context of the ESRC's World Economy and Finance Programme focussing on broader questions of the national and international determinants of financial developments. All interviews were structured along the same lines, with specific questions depending on the country and organization involved. Questions pertained to: (1) structure and role of the organization; (2) main issues in financial governance; (3) policymaking process in bank capital adequacy or sovereign debt restructuring case. I furthermore had access to two sets of interviews conducted in the early and late 1990s by Geoffrey Underhill.[2] In the table below, only the interviews which were directly relevant to the case studies in this thesis are listed. Many interviewees provided me with document sources. When relevant, these are listed below under official documents. Documents which were provided in confidentiality are not listed (these are referred to as confidential document sources in the text).

Date	Name	Affiliation	function
27/03/1992	Welsh	Bankers Association for Foreign Trade	general counsel
02/04/1992	Hawley Haraf	Citi Bank Citi Corp	Government Relations office
03/04/1992 02/10/1992	Mulloy	US Congress	advisor senate committee
03/04/1992	Haseltine Matthews	IIF	deputy MD
24/09/1992	Promisel Ryback	Fed Board of Gov	associate director international finance deputy associate director international baking regulation and supervision
24/09/1992	Miailovich	FDIC	associate director policy and administration
29/09/1992	Hartzell	OCC	deputy controller for international banking and finance

[1] Generous funding of the ESRC (award no. RES-156-25-0009) and the AISSR for the fieldwork involved in conducting these interviews is gratefully acknowledged
[2] I am grateful to prof. Underhill for having had the opportunity to build on those interviews.

23/02/1998	Langton	ISMA	secretary-general
25/02/1998	Crockett	BIS	general manager
25/02/1998	Sicotte	Joint Forum	secretary
25/02/1998	Roberts	BCBS	
22/04/1998	Bader	European Commission	
23/04/1998	Wilms	Banking Federation of the EC	
18/06/1998	Cumming	Federal Reserve Bank of NY	
22/06/1998	Ryback	Fed Board of Gov	associate director of banking supervison and regulation
23/06/1998	Matthews	IIF	
24/06/1998	Walsh	G30	
03/11/2007	Jansen	Both Ends	
16/11/2007	Zhao	China Banking Association	Director of international department
16/11/2007	Lin	People's Bank of China	IMF division
20/11/2007	Lee	Yonsei University	
20/11/2007	Park	Seoul National University	
21/11/2007	Chey	Bank of Korea	economist
21/11/2007	Hahm	Yonsei University	
22/11/2007	Lee	Financial Supervisory Services	Head macro-prudential supervision
22/11/2007	Lee	Korea Institute of Finance	president
23/11/2007	Kim	Korean Development Institute	Director department of macro-economic and financial policies
23/11/2007	Park	Korean Federation of Banks	Research and legal support team
26/11/2007	Kawai	ADBI (formerly MinFin)	dean
27/11/2007	Kinoshita	Formerly FSA	
29/11/2007	Shiina	FSA	Deputy director int. affairs division and supervisory coordination division
29/11/2007	Sorrenti	IBA Japan	Executive director
30/11/2007	Masaaki et al	JBA	Deputy general manager planning & coordination
30/11/2007	Nakata	Bank of Japan	Head of international affairs
24/01/2008	Scutt Thorp	BBA / IBFed	Deputy chief executive Director prudential capital and risk
29/01/2008	Rogers	Jubilee Debt Campaign	

05/02/2008	Walter	BCBS	Secretary-general
06/02/2008	Inderbinen et al	Swiss Federal Finance Administration	Head of IFI section
07/02/2008	Missbach	Berne Declaration	
08/02/2008	Maurer	Foreign Bankers Association	Secretary general
08/02/2008	Lamprecht	Credit Suisse	Head of legislative developments
12/02/2008	Staub	Swiss Bankers Association	
15/02/2008	Brits	Banking Association South Africa	General manager
18/02/2008	Oosthuizen et al	Reserve Bank of South Africa	Advisor bank supervision department
19/02/2008	Hugo	Reserve Bank of South Africa	Deputy head financial markets department
20/02/2008	Steinhauser	Swiss Federal Banking Commission	
20/02/2008	Milton	Reserve Bank of South Africa	Executive management department, G20 unit
27/02/2008	Lamonte	Vml. ResBank, nu private sector	
27/02/2008	Muller	FSB	Head capital markets
14/04/2008	Marx	AGM Capital	
15/04/2008	Destefanis	BCRA	Chief of international relations
15/04/2008	Guidotti	University di Tella	
16/04/2008	Roisenzvit	BCRA	Supervisory coordinator
16/04/2008	Balzarotti	BCRA	
16/04/2008	Vatnik Musalem	Center for Financial Stability	President senior economist
17/04/2008	Barboza	MECON	
17/04/2008	Amengual	ADEBA	director
18/04/2008	Wilson	ABA	economist
22/04/2008	Tingas	FEBRABAN	
23/04/2008	Mansur et al	BCB	Deputy head of department
24/04/2008	Carvalho et al	Fazenda	
25/04/2008	Guimaraes	Fazenda	
17/06/2008	Carreon	Hacienda	Deputy director general financial analysis and international economy
20/06/2008	Diamant	Banxico	
20/06/2008	Graf	Banxico	Manager financial system analysis

20/06/2008	Marino	Banxico	Manager international economic affairs
20/06/2008	Romero	Cofemer	Director financial regulation
25/06/2008	Walsh	OCC	
25/06/2008	Schraa	IIF	Director regulatory affairs
25/06/2008	Rogers	IIF	Deputy director capital markets and emerging markets policy
26/06/2008	Wijnholds	IMF	ECB representative to the EB
26/06/2008	Bhattacharya	G24	director
26/06/2008	Saraiva	IaDB (former BCB)	
27/06/2008	Stevens	CBSB	Senior vice president regulatory policy
02/07/2008	Van der Vossen	IMF	Advisor monetary and capital markets department
02/07/2008	Kiekens	IMF	ED Belgium constituency
02/07/2008	Bakker	IMF	ED Dutch constituency
02/07/2008	Fisher	IMF	PDR
03/07/2008	Barger	Fed Board of Gov	
04/07/2008	Oacha	Hacienda Mexico	
28/08/2008	Reinhardt	BMF	
29/08/2008	Taube	Inwent	
01/09/2008	Zattler	Bankenverband	
01/09/2008	Meyer	BMF	Head of division world economy, currency issues, IMF, G7
01/09/2008	Gross	Offentlicher Banken	Director banking supervision and international economy
04/09/2008	Marburger	Pfandbriefbanken	
20/02/2009	Tenhundfeld	ABA	Senior vice president regulatory policy
20/02/2009	French	FDIC	Deputy director supervision
20/02/2009	Netram	FSR	Director of regulatory and securities affairs
30/03/2009	Jeanmart Dragomin	ESBG	Head of department banking supervision and economic affairs Advisor banking supervision
30/03/2009	Fairhurst	European Financial Services Roundtable	Manager EU affairs

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English summary

This thesis aims to contribute to a better understanding of the relationship between market structures and patterns of governance, to explain why attempts to establish a governance pattern that mitigates financial crises have been less than fully successful (to say the least). The central question informing the project is: *What explains the relationship between market structures and patterns of governance so as to understand the dynamics of the global financial system?* This general concern is explored by focusing on the issue areas of bank capital adequacy standards and the resolution of sovereign debt crises. The relationship between market structures and patterns of governance in both issue areas not only seems to be reciprocal, but also seems to be the key defining factor in developments in these areas. The past decades of cross-border and cross-sector integration of financial markets should therefore be understood as occurring symbiotically with the concurrent shifting patterns of governance. The overarching question above can consequently be broken down into three more specific research questions:

1. How has the pattern of governance shifted in the two policy domains of bank capital adequacy standards and sovereign debt crisis resolution over the period 1980 - 2005? How have the relevant market structures changed over the same period?
2. What are the characteristics of the policymaking process leading to these shifts in the pattern of governance of the two policy domains in global financial governance?
3. What is the role of the policymaking process in both shifts in governance and changes in market structure? In short, how do shifting patterns of governance relate to changes in market structure in each of the two cases?

These research questions are addressed by process-tracing the developments in the two policy domains, through an analysis of qualitative data (semi-structured interviews, policy documents, and archive materials) and quantitative data (market structure data of e.g. the BIS and OECD). The time period in which these cases are examined (1980 – 2005) allows for both within and across case comparison. In both cases, it can be observed that the changes in market structure which have occurred in the two policy domains ('globalisation of the financial system', reflected in bigger, international banks and increased capital market financing of emerging markets) have shifted the preferences of actors and led to the emergence of global-level public policymaking institutions in which private actors are closely involved. These developments facilitated the shift from 'public' governance at the international level (the governance patterns of Basel I and the Baker/Brady plans) to greater private sector self-regulation at the global level (the governance patterns of Basel II and the Collective Action

Clauses –CACs- plus Principles). These developments demonstrate that policy outcomes cannot be explained by state-centric approaches, but that internationally active private actors and the nature of their relationships to crucial state agencies need to be included in the equation. At the same time they demonstrate that the simultaneous globalisation of the financial system and development of new forms of multilevel governance is not driven by exogenous factors.

Furthermore, in both cases the shifting patterns of governance lead to changes in market structures and vice versa. The first global level agreement with respect to bank capital adequacy (Basel I) contributed to the emergence of diversified and international banks with sophisticated risk management practices. This shifted private actor preferences towards the use of in-house risk management models. Public actors followed this preference as they witnessed that this new market structure allowed for the 'gaming' of Basel I with the associated increases in risks. These shifting preferences led to the renegotiation of Basel I. In the case of sovereign debt crisis resolution, the Brady plan, which was developed to tackle the Latin American debt crisis of the 1980s, encouraged capital market financing of emerging markets. This diversified the preferences of private actors and led to a reduced sense of urgency to make progress on this issue. Public actors (specifically the IMF) realized the potential risks accompanying this new market structure for sovereign debt, however. These risks were brought home by the 1995 Mexican financial crisis and subsequent 1997/1998 East Asian crisis which necessitated sums of rescue funding which overburdened the creditor states. The IMF therefore proposed a comprehensive approach to sovereign debt restructuring (the Sovereign Debt Restructuring Mechanism, SDRM), which would entail a global level, public governance pattern for sovereign debt crises. The IMF's proposal was defeated by the influence of private actors in the policymaking process and the lack of support among debtor states, which feared their market access would be hampered by private sector responses.

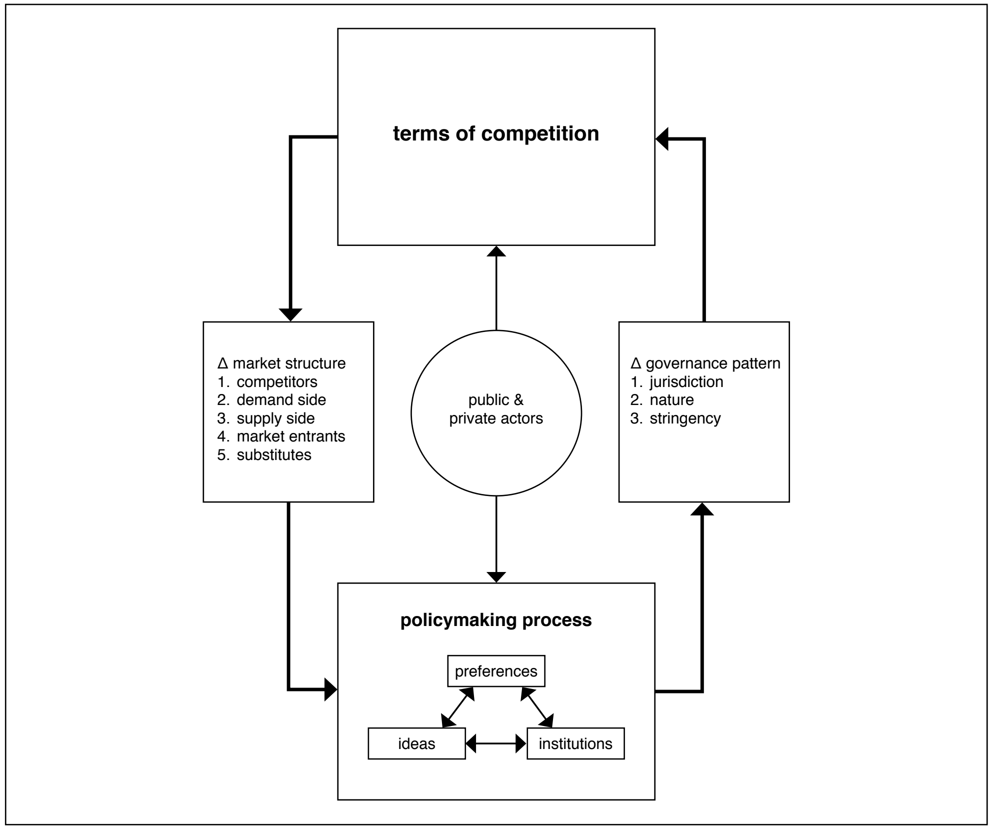
Both cases also demonstrate that public actors continued to play an important role in the policymaking process. Their preferences reflected both a 'theoretical' understanding of how markets should function and their own market position (e.g. on the demand side of sovereign credit). As such, public actor preferences can counterbalance or complement sometimes more narrowly self-interested private actor preferences (e.g. the operational risk issue in the Basel Capital Accord or the emergence of a standard for CACs).

This analysis leads to two core arguments. First, at a general level, it is argued that there is a symbiotic relationship between the changing structure of the market and shifting patterns of governance: changes in the terms of competition lead to changing market structures which generate changes in actor preferences concerning regulation and governance, and the outcome of conflict over divergent actor preferences concerning governance and regulation (the shifts in governance pattern) generates new terms of competition and so forth. Changes in preferences concerning governance therefore appear intimately intertwined with preferences concerning the terms of competition. This feedback loop is shown schematically in the figure on page 235.

The second core argument is that public actors continue to wield crucial influence on

the dynamics of the global financial system, even in the face of the huge growth of financial markets and its cross-border and cross-sector integration. Both public and private actors have an interest in global financial stability, and public actors are crucial in overcoming the collective action problems to achieve this. Furthermore, public actors have an important influence in the global financial system through their role as market players (e.g. on the demand side of sovereign credit). The debate on states in globalised markets seems to be misguided by its implicit state-market dichotomy. An integrated notion of changes in market structures and shifting patterns of governance points to the interaction between public and private actors: it is the collusion of public and private actors in the policymaking process that is the main force behind change. The preferences of public actors in this interaction are linked to their position in the policymaking process and their role as market actor. They hence develop their own position related to their position in the market. Although the policymaking institutions might change, the continuing importance of (certain) public actors in producing authoritative decisions regarding governance patterns does not.

The interaction between governance and market structure



In developing these arguments, this project makes a number of contributions to the academic literature. First of all, the relationship between governance patterns and market structures is conceptualised in a theoretically innovative fashion, overcoming the (implicit) dichotomy between the two which prevails in much of the literature. Overcoming the state-market dichotomy shows the limitations of a focus on either policymaking processes or market interactions alone, and leads to a better understanding of the search for optimal patterns of governance in the context of the realities of power relationships among a diverse range of actors which are simultaneously interacting on markets and trying to satisfy policy preferences. It contributes to the literature by bringing bundles of literature on financial governance from Economics, Political Science, and Sociology closer together, effectively bridging them in an interdisciplinary fashion. This contribution consequently has general relevance for International Political Economy (IPE) scholarship.

A second contribution, related to the first, is the attention paid to the interaction of both public and private actors in the analysis of global and domestic policymaking processes. This is a novel approach particularly at the global level: most studies of international policymaking processes remain either largely intergovernmental (neglecting non-state actors), or focus on private authority. By focussing on the interaction between public and private actors on both the domestic and global level, this thesis furthermore contributes to the debate on the role and agency of the state in globalising markets.

A third major contribution lies in the empirical process-tracing of the two case studies. Comprehensive studies, based on a consistent analytical framework, of the policymaking processes in the domains of bank capital adequacy standards and sovereign debt crisis resolution are wanting. Some literature has emerged discussing recent episodes in these policy domains (post-East Asian crisis and Basel II), but this has not yet been extended to the developments in the wake of the current financial crisis. Moreover, the thesis contributes to the existing literature by building on the historical context through tracing the developments in the cases from the Latin American debt crisis and the Basel I Capital Accord. This allows for a fuller and richer analysis of the complex causal chain which is developed in this research and which is crucial in understanding the dynamics of the global financial system.

Finally, as the current financial crisis gives new urgency to the two policy domains that are the focus of this study, a timely contribution to the policy debate can be made. The first step in achieving a governance pattern better equipped to promote stability is a better understanding of the realities and dynamics of the emerging global-level policymaking process and how this relates to the dynamics of market instability. The analysis of this thesis demonstrated where the room for agency lies; and consequently shows where we can steer the developments in governance to outcomes that are more closely linked to the public good of financial stability and the preferences of a broader range of stakeholders and citizens (as they should be in any democracy). The prime take-away message for policymakers should therefore be that the input legitimacy of financial policymaking must be improved. A wider range of stakeholders should be included, and it should be ensured that these stakeholders engage in substantive discussions on the trade-offs inherent in the global financial system. For example, one practical proposal to achieve this would be 'compulsory' consultations with a wider set of stakeholders. Such consultations would imply that the Basel Committee on Banking Supervision (BCBS) would not only put a consultative paper on its website and wait for responses, but should actively contact Civil Society Organisations (for example labour unions) to solicit their responses. The process should not be allowed to continue without wide-ranging inputs and a public discussion on what the BCBS intends to do with these inputs.

But this policy recommendation should not mean it is only up to the decision-making elites to improve the functioning of the global financial system. Individual citizens should have the opportunity to exit the global casino that has been built. Offering a wider and more transparent choice in the often opaque financial instruments citizens are consuming would empower citizens to make their own choice for the kind of financial system they want. Through such a two-pronged approach of an improved (global) policymaking process and improved opportunities for satisfying market demand of socially responsible financial products, policy space might be created to seek alternatives to the current global financial system and the unbridled expansion of market forces. Also, it brings us back to the prime message of this thesis that has relevance for scholars, policymakers and citizens alike: we should not think of politics or market behaviour when analysing the global financial system, we should develop an integrated understanding of politics and markets which can then be harnessed to design courses of action (on markets and in politics) that promote a global financial system that serves our common future.

Nederlandse samenvatting:

Publiek krediet, mededinging op de markt en veranderende governance-patronen

Sinds de val van het Bretton Woods systeem van monetaire en financiële sturing (governance) kenmerkt het financiële systeem zich door snelle expansie, mondiale integratie en desegmentering. Op het moment van schrijven (september 2011) is dit uitgemond in de grootste financiële en economische crisis sinds de Grote Depressie uit de jaren dertig van de vorige eeuw. Oktober 2008 getuigde Alan Greenspan voor het Amerikaanse Congres over de crisis. Als gouverneur van de Amerikaanse Federal Reserve was hij sinds 1987 een van de beeldbepalende internationale beleidsmakers, en een groot voorstander van een 'marktgeoriënteerd' model van beperkte regulering van het financiële systeem. Onder druk van verscheidene leden van het Congres, geeft hij toe dat: *"[there is a] flaw in the model that I perceived is a critical functioning structure that defines how the world works."* De crisis onderstreepte, kortom, dat de regulering van het mondiale financiële systeem tekortschoot. Dit roept de vraag op welk model dan beter in staat is de ontwikkeling van het mondiale financiële systeem te analyseren. Ook is het de vraag hoe het model van Greenspan zo dominant is geworden in de mondiale beleidsdiscussies. Waarom blijkt het zo moeilijk om het mondiale collectieve goed van financiële stabiliteit te garanderen en daarmee economische ontwikkeling te stimuleren?

Kijkend naar de afgelopen decennia lijkt er een wisselwerking op te treden tussen de ontwikkelingen in de financiële markten en de governance van deze markten. De grensoverschrijdende en sector-overschrijdende integratie van financiële markten lijkt een symbiotische relatie met de ontwikkeling van governance-patronen te hebben. Als we het mondiale financiële systeem willen begrijpen, zullen we dus deze wisselwerking moeten analyseren. De centrale vraag in deze studie is daarom: Wat verklaart de relatie tussen marktstructuur en governance-patronen, en hoe helpt dit ons begrip van de dynamiek van het mondiale financiële systeem? Deze centrale vraag wordt onderzocht aan de hand van case studies op twee beleidsterreinen: de internationale onderhandelingen over standaarden voor kapitaaltoereikendheid voor banken en die met betrekking tot mechanismen voor het oplossen van soevereine schuldencrises. Dit leidt tot drie specifiekere onderzoeksvragen die centraal staan in deze studie:

1. Hoe is het governance-patroon op de beleidsterreinen van kapitaaltoereikendheid van banken en het oplossen van soevereine schuldencrises veranderd in de periode 1980 – 2005? En hoe zijn de marktstructuren veranderd in dezelfde periode?

2. Hoe kan het beleidsproces dat tot deze veranderingen heeft geleid gekarakteriseerd worden?
3. Welke rol speelt het beleidsproces in de veranderingen in governance-patroon en marktstructuur? Kortom, hoe verhouden veranderende governance-patronen zich tot veranderende marktstructuren in beide casussen?

Om deze vragen te beantwoorden worden de ontwikkelingen in het toezicht op de kapitaal-toereikendheid van banken (samen te vatten onder de noemer Bazelse Kapitaalakkoorden) en de ontwikkelingen in de resolutie van soevereine schuldencrises (als een van de centrale punten in het debat over een nieuwe mondiale financiële architectuur na de Azië-crisis) geanalyseerd. In beide cases wordt gekeken hoe de patronen van governance en de marktstructuren veranderd zijn over de laatste 25 jaar, en hoe we deze veranderingen kunnen begrijpen. Hierbij is in beide gevallen gebruik gemaakt van een combinatie van kwalitatieve data (interviews, beleidsdocumenten, en archiefmateriaal) en kwantitatieve data (statistische databases van o.a. de BIS en OECD).

Beide casussen laten zien dat de veranderingen in de marktstructuur - kortweg te omschrijven als de 'globalisering' van het financiële systeem, zoals te zien aan de opkomst van grote, internationaal actieve banken en kapitaalmarktfinanciering van opkomende markten - leiden tot nieuwe voorkeuren van relevante actoren voor governance-patronen. Ook leiden deze veranderingen tot de opkomst van mondiale beleidsfora waarin internationaal actieve banken een relatief grote stem hebben. Door de grote invloed van private banken op het beleid ten aanzien van de financiële sector heeft een verschuiving plaatsgevonden van publieke vormen van governance (zoals vastgelegd in het eerste Bazelse Kapitaalakkoord of de plannen van Baker en Brady die gericht waren op het oplossen van de Latijns Amerikaanse schuldencrisis van de jaren 80) naar zelfregulering van de private sector (zoals meer het geval is onder het tweede Bazelse Kapitaalakkoord en in de mechanismen om soevereine schuldencrises op te lossen). Als we willen verklaren hoe het governance-patroon voor het mondiale financiële systeem is ontstaan zullen we ons dus rekenschap moeten geven van de invloed en voorkeuren van grote, internationaal actieve banken. De globalisering van het mondiale financiële systeem loopt gelijk op met het ontstaan van nieuwe sturingsmechanismen, die een grote rol geven aan 'de markt'.

Deze symbiotische ontwikkeling is niet toevallig, 'globalisering' is geen autonoom proces. Het eerste Bazelse Kapitaalakkoord zorgde voor mondiale harmonisatie van regulering van banken, en droeg daardoor bij aan de opkomst van internationaal actieve banken die 'geavanceerde' risicomanagementtechnieken toepasten. Deze banken ontwikkelden een voorkeur voor mondiale regulering die nauw aansloot bij hun eigen systemen. Tegelijkertijd ontdekten de toezichthouders dat het eerste Kapitaalakkoord teveel speelruimte bood aan de banken, en zochten daarom naar nieuwe standaarden die beter het risico konden beheersen. De samenkomst van deze voorkeuren leidde tot een heronderhandeling van Bazel I, waarbij de belangenvereniging van de internationale banken (het IIF) een prominente invloed had op de uitkomst.

Een vergelijkbare ontwikkeling trad op in de casus van soevereine schuldencrises. Het Brady plan, dat erop gericht was de Latijns Amerikaanse schuldencrisis van de jaren 80 op te lossen, moedigde kapitaalmarktfinanciering van opkomende markten aan. Hierdoor ontstonden echter nieuwe problemen met de coördinatie van crediteuren rond crises. Dit werd pijnlijk duidelijk met een serie crises in opkomende markten in de tweede helft van de jaren 90. In reactie kwam het IMF met het meest prominente beleidsvoorstel: een Sovereign Debt Restructuring Mechanism (SDRM). Dit mechanisme zou een breuk betekenen met de marktgeoriënteerde manier van reguleren, door op mondiaal niveau een soort faillissementshof voor landen op te richten. Het voorstel werd echter getorpedeerd door een coalitie van internationale banken en belangrijke opkomende markten die vreesden dat hun marktpositie zou verslechteren door het SDRM.

Ondanks de grote invloed van internationaal actieve banken op de veranderingen in de governance-patronen, laten beide casussen ook zien dat bepaalde publieke actoren, zoals het IMF, een belangrijke rol blijven spelen in het beleidsproces. De voorkeuren van deze actoren worden bepaald door aan de ene kant een 'theoretisch' idee over de efficiëntie van mondiaal geïntegreerde financiële markten en aan de andere kant de rol van deze actoren als marktpartij, bijvoorbeeld bij het financieren van hun eigen staatsschulden. Deze publieke belangen fungeren als tegenwicht tegen de meer op beperkt eigenbelang gerichte private partijen. Een voorbeeld hiervan is de ontwikkeling van een internationale standaard voor collectieve actie clausules in staatsobligaties, die doorgang vond terwijl het SDRM afgeserveerd werd.

Deze analyse leidt tot twee stellingen die de kern van dit proefschrift vormen. Allereerst wordt betoogd dat er een symbiotische relatie is tussen veranderingen in de marktstructuur en veranderingen in governance-patronen. Met andere woorden, veranderingen in de vorm van mededinging leiden tot veranderingen in de structuur van de markt. Deze veranderingen leiden op hun beurt tot veranderingen in de voorkeur van publieke en private partijen voor bepaalde governance-patronen. De uitkomst van de onderhandelingen over de governance-patronen brengt vervolgens veranderingen in de vorm van mededinging te weeg (enzovoorts). De veranderingen in voorkeuren met betrekking tot governance-patronen hangen dus nauw samen met voorkeuren wat betreft concurrentie op de markt. Deze feedbackloop verklaart de ontwikkelingen in het mondiale financiële systeem.

De tweede stelling is dat bepaalde publieke actoren nog steeds een cruciale invloed hebben op de dynamiek van het mondiale financiële systeem, ondanks de enorme groei van het financiële systeem en de stevige positie van banken in internationale onderhandelingen. Zowel publieke als private partijen hebben een belang bij financiële stabiliteit, en publieke actoren zijn noodzakelijk om deze stabiliteit te bereiken. Bovendien zijn publieke actoren zelf grote spelers in het financiële systeem (bv. als lenende partijen) en hebben daarom een belangrijke stem in de ontwikkelingen. Door de mondialisering van het systeem is de macht

van overheden wel steeds meer beperkt tot een select gezelschap van ministers van financiën en centrale bankiers die op mondiaal niveau het beleid coördineren in bijvoorbeeld de G7.

Door deze stellingen uit te werken en te onderbouwen, levert dit proefschrift een tijdige bijdrage aan het academische en publieke debat over het mondiale financiële stelsel. Door het (impliciete) onderscheid dat velen maken tussen overheid en markt te overbruggen worden de beperkingen die een focus op enkel beleidsprocessen ('politiek') of enkel marktontwikkelingen ('de vrije markt') met zich meebrengen overwonnen. De ontwikkelingen in het mondiale financiële systeem zijn een resultaat van de wisselwerking tussen politiek en markt, een resultaat van de zoektocht naar economisch optimale governance-patronen in de context van politieke machtsverhoudingen en marktontwikkelingen.

Een tweede bijdrage die dit proefschrift levert –voortbouwend op de eerste - is de aandacht voor zowel publieke als private actoren in de analyse van de beleidsprocessen. Tot nog toe richtte onderzoek naar de internationale onderhandelingen over de governance van het mondiale financiële systeem zich nog teveel op de onderhandelingen tussen staten. Hierbij werd echter de cruciale rol van internationaal actieve banken in de onderhandelingen onderbelicht. De private partijen hebben een zeer grote invloed op de uitkomst, die dan ook relatief gunstig is voor verdere expansie van het financiële systeem en zich richt op marktgeoriënteerde governance-patronen. Tegelijkertijd moet niet uit het oog verloren worden dat een select gezelschap van overheidsactoren wel degelijk bepalend zijn voor de uitkomst van de onderhandelingen, zij het dat ze hun oren teveel lijken te laten hangen naar de private partijen.

Tot slot is de empirische analyse die ten grondslag ligt aan het betoog van dit proefschrift een waardevolle toevoeging aan de literatuur. Niet eerder werden de twee casussen op een structurele manier geanalyseerd over de periode die dit proefschrift dekt. Hierdoor ontstaat een beter beeld van de onderliggende trends in het mondiale financiële systeem dan een focus op een van de casussen of een kortere tijdsperiode mogelijk zou maken.

Naast de academische bijdrage die dit proefschrift levert, zijn de beleidsimplicaties van de analyse minstens zo belangrijk (zeker in het licht van de huidige crisis). De analyse laat de kwalijke gevolgen van eenzijdige belangenvertegenwoordiging in het beleidsproces zien. Als we willen dat governance-patronen beter in staat zijn de risico's inherent aan een mondiaal geïntegreerd financieel systeem in te dammen, dan zou het goed zijn een bredere groep belanghebbenden in het beleidsproces te betrekken. Een praktisch voorstel hiervoor is om consultaties met een bredere groep belanghebbenden 'verplicht' te maken. Met andere woorden: consultatiebijdragen van diverse maatschappelijke organisaties zouden niet langer vrijblijvend zijn, maar een noodzakelijke voorwaarde om de financiële regulering verder te ontwikkelen. Net zoals in bedrijven sommige ingrijpende beslissingen niet genomen kunnen worden zonder een advies van de ondernemingsraad, is het mogelijk om vast te leggen dat bijvoorbeeld werkgevers en werknemers proactiever betrokken worden bij de ontwikkeling van internationale financiële standaarden door een expliciet adviesverzoek en het aanbod van hulp bij technische vragen.

Maar het is niet alleen aan de beleidsmakers om de werking van het financiële systeem beter aan te laten sluiten bij de wensen van het brede publiek, ook individuele burgers zou de mogelijkheid geboden moeten worden om bijvoorbeeld te kiezen voor financiële producten met een laag risico of investeringen in duurzame sectoren. De ontwikkelingen in het mondiale financiële systeem worden in sterke mate gedreven door financiële instellingen die met het geld van burgers (grensoverschrijdende) transacties doen – al dan niet speculatief. Zo worden hedge funds bijvoorbeeld voor een significant deel gefinancierd door reguliere banken en pensioenfondsen. Burgers zouden moeten kunnen kiezen of hun middelen hiervoor beschikbaar zijn, zodat ze het mondiale financiële casino eventueel kunnen verlaten.

Door deze tweetrapsraket van een opener beleidsproces en meer keuze voor burgers kan beleidsruimte gecreëerd worden om alternatieven te ontwikkelen voor het huidige mondiale financiële systeem en haar ongebreidelde expansie. Dit brengt ons terug bij de belangrijkste boodschap van dit proefschrift: we moeten niet denken dat de oplossing ligt bij 'de politiek' of 'de markt', maar we moeten het mondiale financiële systeem begrijpen als een symbiose van markt en politiek, waardoor geïntegreerde actie op beide terreinen nodig is om het algemeen belang te behartigen.