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

Blom, J.G.W.

Publication date
2011

and Finance program enabled extending my world tour with a number of emerging market visits to collect interview and other data ('National and International Aspects of Financial Development', award no. RES-156-25-0009). The mobility funds of the EU FP6 Network of Excellence 'Global Governance, Regionalisation and Regulation: the Role of the EU' (GARNET, contract no. CIT3-CT-2005-513330) made it possible to have stop-overs at the London School of Economics and Sciences Po Bordeaux. I would also like to thank these institutes for their hospitality and dr. Josselin (LSE) and prof. dr. Bach (Sciences Po) for their valuable mentoring. Last but not least, the EU FP7 consortium award 'Politics, Economics, and Global Governance: the European Dimensions' (PEGGED, award no. 217559) made it possible to focus on finishing the thesis in the final months. I am indebted and grateful to all of these sponsors for allowing me to complete my journey.

Amsterdam, September 2011

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.

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.

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

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 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.

[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.

[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

[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.

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

[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

[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.

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.

[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 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

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

[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 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).

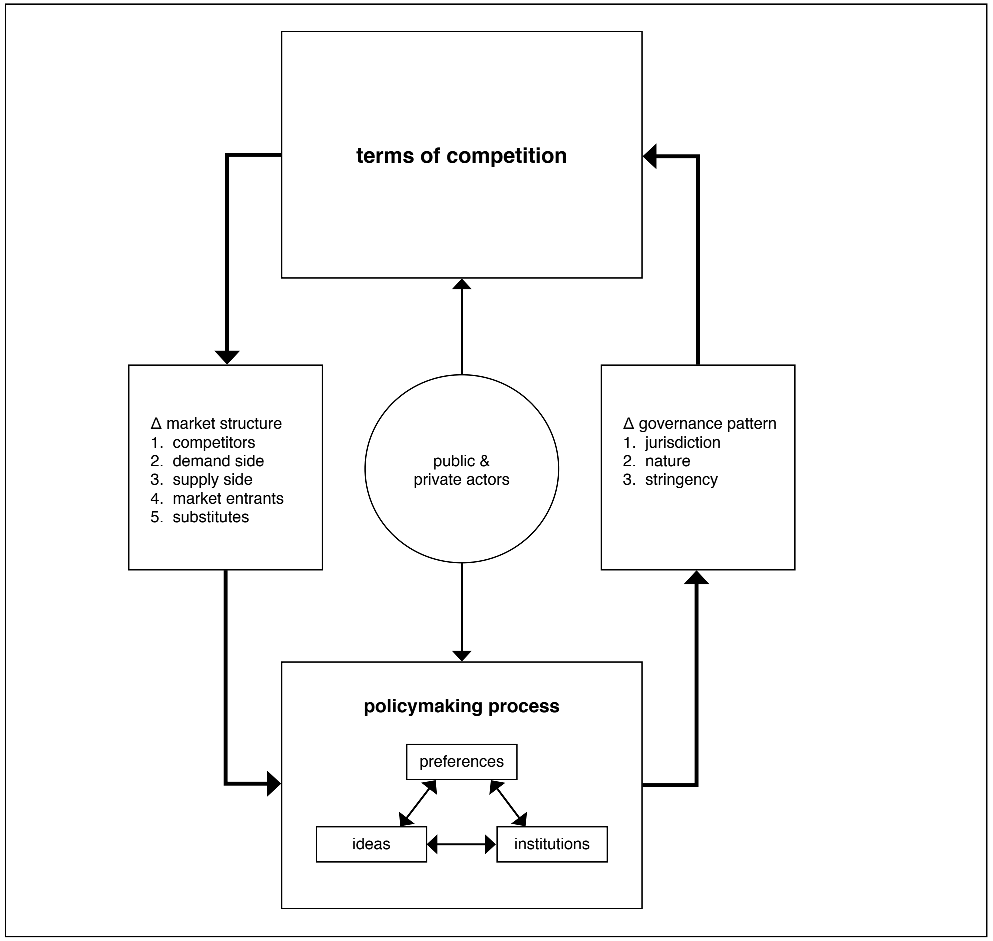
This preliminary analysis of the cases points to the relevance of the approach taken in this thesis, which can be summarised in two core arguments. First, at the most general level, it is argued that there is a symbiotic relationship between the changing structure of the market and shifting patterns 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

[48] E.g. Kapstein, 1994.

[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.