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

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**Publication date**  
2011

[Link to publication](#)

#### **Citation for published version (APA):**

Blom, J. G. W. (2011). *Banking on the public: market competition and shifting patterns of governance*. [Thesis, fully internal, Universiteit van Amsterdam].

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## 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’<sup>1</sup>). 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

<sup>1</sup> See Engelen, 2008 for a discussion of the concept of financialisation.

reducing ‘financial repression’ (especially in emerging markets).<sup>2</sup> 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.<sup>3</sup> 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).<sup>4</sup>

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

<sup>2</sup> Often labelled ‘neoliberalism’ or more specifically the ‘Washington Consensus’ (Williamson, 1990).

<sup>3</sup> See for example Boughton, 2002.

<sup>4</sup> 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.<sup>5</sup>

The institutional embodiments of the Bretton Woods system were two ‘sister’ institutions, the IMF and the World Bank.<sup>6</sup> The IMF was formally established in December 1945 with the founding 29 member states signing the Articles of Agreement.<sup>7</sup> 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.<sup>8</sup>

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.<sup>9</sup> 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

<sup>5</sup> The concept of embedded liberalism was introduced by Polanyi, 2001(1944) and applied to the Bretton Woods context by Ruggie, 1982.

<sup>6</sup> 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.

<sup>7</sup> The following factual information on the IMF membership, staff, etc. is from [www.imf.org](http://www.imf.org) (accessed March 2011).

<sup>8</sup> Pauly, 1997, p. 81.

<sup>9</sup> 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.<sup>10</sup>

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.<sup>11</sup> 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).<sup>12</sup> 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<sup>13</sup> (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.<sup>14</sup> 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

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.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup>

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.<sup>18</sup> 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.<sup>19</sup>

<sup>10</sup> 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.

<sup>11</sup> See Schilperoort, 2010 for an overview of the role and responsibilities of the Fund, also in light of the current crisis.

<sup>12</sup> An IMF recruiter once boasted to me that the IMF employs the largest concentration of postgraduate degree macroeconomists in the world.

<sup>13</sup> 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.

<sup>14</sup> 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.

<sup>15</sup> Strange, 1976, chapter 2.

<sup>16</sup> Pauly, 1997, chapter 5.

<sup>17</sup> 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).

<sup>18</sup> Burn, 1999, p. 228.

<sup>19</sup> 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.<sup>20</sup> 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.<sup>21</sup> 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.<sup>22</sup>

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).<sup>23</sup> 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.<sup>24</sup>

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.<sup>25</sup> 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

<sup>20</sup> 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.

<sup>21</sup> Strange, 1976, p. 178.

<sup>22</sup> Strange, 1976.

<sup>23</sup> Helleiner, 1994, p. 83-84. See Burn, 1999 on the distinction between Eurocurrency and Eurobond markets.

<sup>24</sup> Moran, 1991, p. 63 - 64.

<sup>25</sup> Triffin, 1960.

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.<sup>26</sup> To pre-empt the Triffin dilemma, the US financial authorities had a preference for controlling the outflow of capital.<sup>27</sup> 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.<sup>28</sup> Because of the lack of improvement in the American balance of payments position, it was extended to bank loans in 1965.<sup>29</sup>

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).<sup>30</sup>

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,<sup>31</sup> 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.<sup>32</sup> 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

<sup>26</sup> Block, 1977, chapter 6.

<sup>27</sup> 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.

<sup>28</sup> Helleiner, 1994, p. 85.

<sup>29</sup> Aronson, 1977, p. 173.

<sup>30</sup> Aronson, 1977, p. 83/84.

<sup>31</sup> Aronson, 1977, p. 70.

<sup>32</sup> 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.<sup>33</sup>

While private sector lobbying had led to the existence of the loopholes in the first place,<sup>34</sup> 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.<sup>35</sup> 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 1, 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

<sup>33</sup> 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.

<sup>34</sup> Helleiner, 1994, p. 88/89.

<sup>35</sup> 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).<sup>36</sup> 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.<sup>37</sup>

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<sup>38</sup> 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.

<sup>36</sup> On regulation Q and the cost advantage as factors in the growth of Euromarkets, see Dale, 1984, p. 12-13.

<sup>37</sup> 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.

<sup>38</sup> 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)<sup>39</sup>**

	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.<sup>40</sup> 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).<sup>41</sup> 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.<sup>42</sup>

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

<sup>39</sup> 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

<sup>40</sup> Helleiner, 1994, p. 96 provides this explanation for the emergence of the G10.

<sup>41</sup> See IMF, 2001 or Block, 1977, p. 178-179 for discussions of the GAB.

<sup>42</sup> IMF, 2001, p. 73 – 74.

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.<sup>43</sup> 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.<sup>44</sup>

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.<sup>45</sup> 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.<sup>46</sup>

<sup>43</sup> 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.

<sup>44</sup> Strange, 1976, p. 176 – 177.

<sup>45</sup> Aronson, 1977, p. 142.

<sup>46</sup> 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).<sup>47</sup> 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.<sup>48</sup> 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.<sup>49</sup> 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.

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.<sup>50</sup> 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.

<sup>47</sup> 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.

<sup>48</sup> Block, 1977, p. 194.

<sup>49</sup> Aronson, 1977, p. 102 – 110 and Helleiner, 1994, p. 111.

<sup>50</sup> 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.<sup>51</sup> 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.<sup>52</sup> 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.<sup>53</sup> It is estimated that by 1981, one third of net international bank claims were comprised of medium-term roll-over syndicated international loans.<sup>54</sup> Table 3.4 shows the impact this development had on banks’ balance sheets.

<sup>51</sup> Aronson, 1977, p. 164. See also Llewellyn, 1985, p. 212.

<sup>52</sup> See for example Llewellyn, 1985.

<sup>53</sup> 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.<sup>55</sup>

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.<sup>56</sup> 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.<sup>57</sup> This syndication was one of the key innovations in the financial markets of the 1970s.<sup>58</sup> American and European authorities generally refrained from regulating bank activities

<sup>54</sup> Pecchioli, 1983, p. 34.

<sup>55</sup> Cohen, 1982.

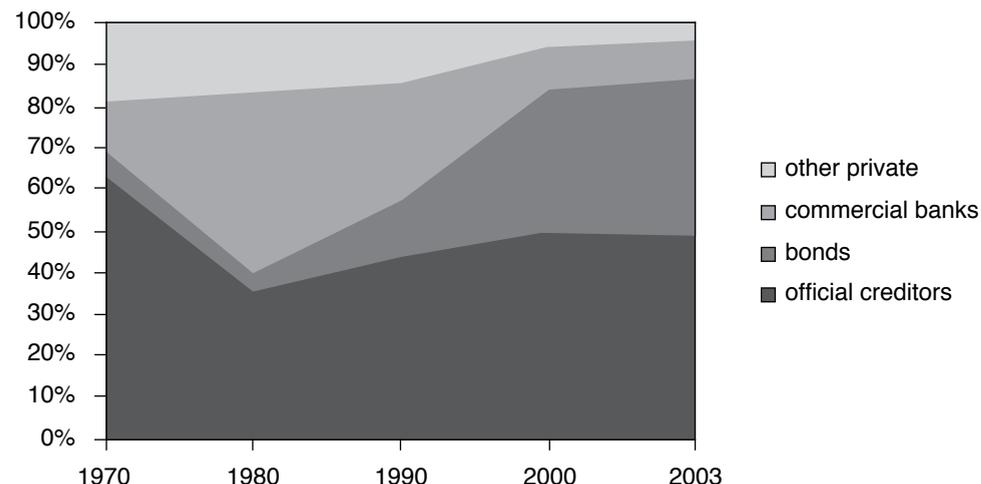
<sup>56</sup> Llewellyn, 1985, p. 208.

<sup>57</sup> Stallings, 1990, p. 5 (table 1).

<sup>58</sup> 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.”<sup>59</sup>

**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).<sup>60</sup> 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.

<sup>59</sup> Cited by Peccioli, 1983, p. 89.

<sup>60</sup> 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.<sup>61</sup> 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

<sup>61</sup> Helleiner, 1994, p. 173.

in the US preference for a less Eurocentric forum.<sup>62</sup> 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.<sup>63</sup>

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.<sup>64</sup> 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.”<sup>65</sup> In other words, the G7 advocated a governance pattern of managed exchange rates or ‘dirty floats’.

<sup>62</sup> 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.

<sup>63</sup> 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.

<sup>64</sup> Aronson, 1977, p. 151.

<sup>65</sup> 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.<sup>66</sup> 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.<sup>67</sup> 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.”<sup>68</sup> It presents itself as “a private, non-profit international body (...) [that aims] to deepen understanding of international economic and financial issues.”<sup>69</sup> 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.”<sup>70</sup> 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.<sup>71</sup> 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

<sup>66</sup> See Baker, 2010 for an elaboration of the concept of apex forums.

<sup>67</sup> 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](http://www.group30.org)) and which is unsurprisingly rather positive about the G30’s achievements. See also Tsingou, 2007 for a more nuanced view.

<sup>68</sup> MacRae, 1990, p. 88.

<sup>69</sup> [www.group30.org](http://www.group30.org).

<sup>70</sup> Edwin Deagle quoted in MacRae, 1990, p. 77.

<sup>71</sup> Tsingou, 2007.

a coordinated approach to debt renegotiations with Brazil.<sup>72</sup> The first official Paris Club debt workout took place in 1956 with Argentina. The US appears to have joined only in 1964,<sup>73</sup> 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.<sup>74</sup>

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.<sup>75</sup>

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.<sup>76</sup> 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.<sup>77</sup> 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

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.<sup>78</sup>

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.<sup>79</sup> 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."<sup>80</sup> The BIS was seen as "proposed, designed, and backed by financiers and central bankers."<sup>81</sup> 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).<sup>82</sup>

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

<sup>78</sup> De Jong & Van der Veer, 2010, p. 144.

<sup>79</sup> 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.

<sup>80</sup> BIS statutes of 1930, cited by Seabrooke, 2006, p. 141.

<sup>81</sup> Simmons, 1993, p. 362.

<sup>82</sup> Simmons, 1993, p. 398 - 401.

<sup>72</sup> 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.

<sup>73</sup> Rieffel, 2003, p. 58 (footnote 4).

<sup>74</sup> 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.

<sup>75</sup> See De Jong and Van de Veer, 2010 on this point.

<sup>76</sup> Rieffel, 2003, p. 68.

<sup>77</sup> Brown & Bulman, 2006, p. 12-13.

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).<sup>83</sup> The ‘deputy’ board members were originally appointed from the private sector.<sup>84</sup> 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.<sup>85</sup> 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.<sup>86</sup> 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.<sup>87</sup>

**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.”<sup>88</sup> 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.<sup>89</sup> The BCBS is semi-autonomous within the BIS, in the sense that G10 governors rarely overturn proposals by the Committee.<sup>90</sup> 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).<sup>91</sup>

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.<sup>92</sup> However, banks became increasingly aware of regulatory differences between countries and the administrative burdens these entailed. Internationalised

<sup>83</sup> Factual information from [www.bis.org](http://www.bis.org) (accessed March 2011).

<sup>84</sup> Seabrooke, 2006, p. 142.

<sup>85</sup> Aronson, 1977.

<sup>86</sup> Seabrooke, 2006, p. 143.

<sup>87</sup> Kapstein, 1994, p. 44.

<sup>88</sup> BIS, July 2006, p. 1.

<sup>89</sup> In light of the current financial crisis, membership of the BCBS has been widened to represent the G20.

<sup>90</sup> Off-the-record interview with public official, 1998.

<sup>91</sup> Off-the-record interview with public official, 1998.

<sup>92</sup> 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.<sup>93</sup> 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.<sup>94</sup> 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."<sup>95</sup> Many supervisors had historically analysed capital

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

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.<sup>99</sup>

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.<sup>100</sup> 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.<sup>101</sup> The method of computing four of these ratios, specifically concerning solvency, had been developed by the Banking Advisory Committee of the European Community.<sup>102</sup> 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

<sup>96</sup> Kapstein, 1994, p. 106 - 107.

<sup>97</sup> Norton, 1995, p. 183.

<sup>98</sup> Reinicke, 1995, p. 166.

<sup>99</sup> Wood, 2005, p. 75-76.

<sup>100</sup> 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.

<sup>101</sup> Directive 77/780/EEC, article 6.1.

<sup>102</sup> 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).

<sup>93</sup> Wood, 2005, p. 54.

<sup>94</sup> Wood, 2005, p. 56.

<sup>95</sup> BCBS, 1981, quoted in Norton, 1995, p. 183.

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 preferences for governance. These new preferences were reflected in the emergence of a number of new policy-making 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.<sup>103</sup> 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.<sup>104</sup> It is noteworthy that the Managing

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 tabs 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.<sup>105</sup> 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).<sup>106</sup> 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.<sup>107</sup>

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.”<sup>108</sup> 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).<sup>109</sup> 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.”<sup>110</sup> 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).<sup>111</sup>

<sup>105</sup> IMF Archives, 4 August 1983.

<sup>106</sup> www.iif.com, accessed March 2011.

<sup>107</sup> Off-the-record interview with private actor.

<sup>108</sup> IIF, 13 June 1983.

<sup>109</sup> IMF Archives, 4 August 1983, p. 3–4.

<sup>110</sup> IMF Archives, 4 August 1983, p. 5.

<sup>103</sup> Oliveri, 1992, chapter 1.

<sup>104</sup> Surrey & Nash, 1984.

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.<sup>112</sup> 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.<sup>113</sup>

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.<sup>114</sup> Monetarism had already emerged in the 1950s and 1960s and is closely associated with the work of Milton Friedman.<sup>115</sup> 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.<sup>116</sup> 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.

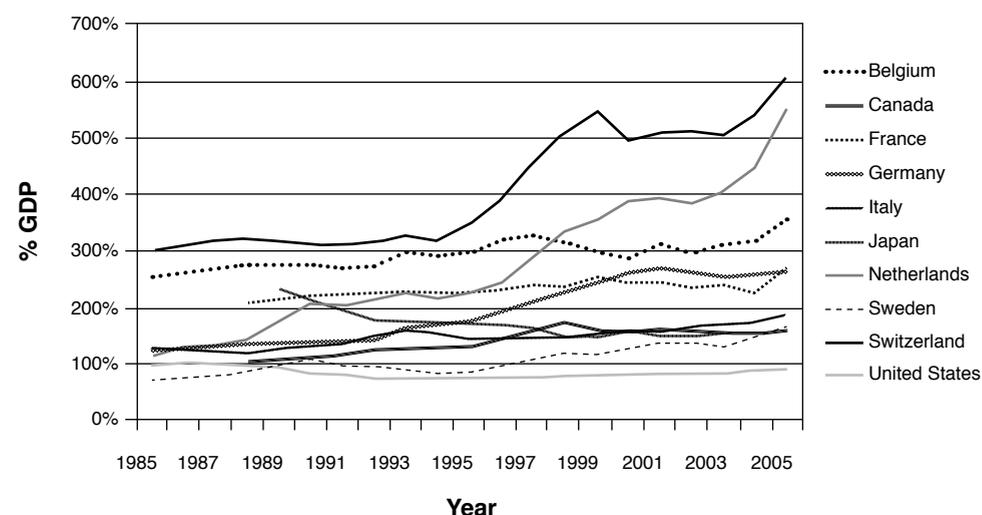
However, an equally important explanation for the rise of financialisation were the

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.<sup>117</sup>

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.<sup>118</sup> 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.<sup>119</sup> 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.

<sup>117</sup> See Underhill, 1997 for country examples. See also Moran, 1986.

<sup>118</sup> See Plender, 1987 for an analysis of the Big Bang in the wider context of the liberalisation of the financial system.

<sup>119</sup> IMF, 1998.

<sup>111</sup> Off-the-record interview source.

<sup>112</sup> Interview with IIF representatives, Washington DC, 25 June 2008.

<sup>113</sup> 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).

<sup>114</sup> Williamson, 1990.

<sup>115</sup> The seminal references are Friedman, 1956 and Friedman & Schwartz, 1964.

<sup>116</sup> Boughton, 2004 discusses its impact on IMF policy.

border and cross-sector market integration) greatly increased over the course of the 1980s.<sup>120</sup> 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.<sup>121</sup> 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<sup>122</sup>).

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.<sup>123</sup> 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

<sup>120</sup> Prasad et al, 2003, especially figure 2 and p. 14. See also Quinn, 1997.

<sup>121</sup> 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.

<sup>122</sup> Horn, forthcoming 2011.

<sup>123</sup> 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.<sup>124</sup>

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

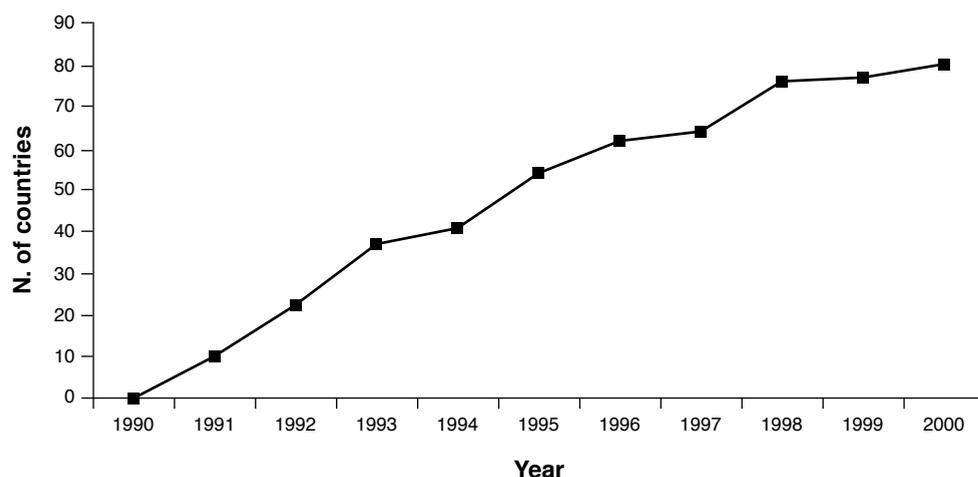
Source: IMF, 1998, tableA5.9 (p. 187).

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.<sup>125</sup> With respect to central banks, the rise in

<sup>124</sup> 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.<sup>126</sup>

**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.

<sup>125</sup> Gill, 1998.

<sup>126</sup> 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.<sup>127</sup> 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 policy-making 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.

<sup>127</sup> Baker, 2006, p. 27