# III-1.10: Global Financial Integration, Thirty Years on. From reform to crisis

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**Complete reference: Geoffrey R. D. Underhill, Jasper Blom, Daniel Mügge (eds.), *Global Financial Integration, Thirty Years on. From reform to crisis*, Cambridge University Press, 2010, 376p.**

## MAIN INFORMATION

The purpose of this collective work is to understand the causes of the financial crisis. It has a strong international dimension and draws in both legal and economic science. Although composed of independent contributions from each other, it relies on a general demonstration, summary of which will largely be the focus of this first bibliographic report, the importance of justifying the work that results in three successive bibliographic reports. Furthermore, the book focuses on the specific issue of governance in international finance, which runs through regulatory issues, but one cannot be reduced to the other and vice versa.
Therefore in all three bibliographic records, abstracts will be more or less developed on the contributions, depending on whether they directly concerned by regulation, in which case they will be preferred or more remote areas, in which case they will shortly discussed.

## CONTEXT AND SUMMARY

*"Global Financial Integration, Thirty Years on. From reform to crisis"* combines many academic contributions on international financial governance that each offer original and in-depth analysis of the financial crisis' causes. To safeguard the authors' legal and economic reasoning, the bibliographical report has been divided in three parts and will be brought to *The Journal of Regulation*'s readers in three successive issues.

***"Global Financial Integration, Thirty Years on. From reform to crisis"*** mainly describes the various reform movements in financial governance that occurred before the 2007-9 crisis. The volume suggests analyzing the several reasons why pre-crisis global financial governance revealed itself as incapable of preventing the occurrence of new crises. The volume first suggests that the last two decades have witnessed **tremendous changes in the nature of the state's involvement in the economy and important changes in the balance of power**. Western States along with International Financial Institutions (IFFs) have embraced and encouraged the shift of part of the responsibility for regulating and monitoring markets from the hands of regulators to the hands of private investors themselves. Such behavior reveals a dramatic shift in power away from states in the global financial realm.

Moreover, along with financial globalization, the influence of private market actors has increased within the policy-making process, leaving aside broader sets of interests and obliging public authorities to respond by adopting market-based approaches to regulation, supervision and corporate risk management. Policy makers deemed that markets were best at understanding and pricing risk while governments' interventions were usually inefficient and distorting. **The pre-crisis financial governance was therefore characterized by a change in the balance of power between public authorities and private interests and an**

**accompanying transformation in the notion of the public interest that defines the financial order, raising issues in terms of input and output legitimacy as well as accountability**.

And while the necessity of regulatory changes for the financial system was always a source of convergence, US and European institutions nonetheless supported **deregulation, while developing countries were caught in deliberative forums (Basel Committee, IOSCO)** in which their vote was either non existent or undermined. This trend led to the development of **cross-borders market-oriented standards**, whether or not they were appropriate for developing countries, which itself led to the propagation of market-based international standards. Moreover, the latter were either too flexible in their implementation or lightly enforced in domestic law, due to the influence that national-level private sector actors have on constraining, modifying, and sometimes blocking, the implementation of international standards at the domestic level.

Contrary to the view that liberalized financial markets would play a disciplining role, dependence on financial swings and private sector influence have encouraged the adoption of pro-cyclical monetary policies, even though the recent crisis revealed how governance of the system should not have been completely entrusted to the private domain of the market. Indeed, the volume demonstrates that **unaccountable private actors participated in a somewhat closed policy community which has led to policy capture and therefore to some countries' defiance towards western standards.** Inevitably, the flawed input-side of financial governance (due to capture or lack of emerging countries representation) tainted its output (its effectiveness and its implementation potential). It is today recognized that policy failures that led to the crisis were originally contained within the **G7 reforms which had encouraged financial governance to be overly responsive to private sector preferences.**

In this view, G7 pre-crisis reforms were either too market-oriented to be efficient or simply not implemented by certain countries which did not feel as though such standards had both the input-side legitimacy and the output side legitimacy to deserve implementation. **This trend encouraged regionalism and decentralizing trends in global financial governance.** Therefore, the pre- 2008 crisis regulatory environment was made up of incoherent systems of global financial governance, with public authorities in different parts of the world working in different directions.

**The volume asserts that the global financial architecture needs to be more compatible with legitimate national economic development aspirations, political processes, and distributive justice** (whereas pre-crisis financial governance occurred in a fragmented and decentralized international political environment). Indeed, developing countries have had relatively little influence on the development of the existing international financial architecture, whereas the latter has much been under policy capture, indicating a lack of input-side legitimacy within the current international financial architecture, thus in turn limiting the out-put side legitimacy (or effectiveness) of global governance. Authors cite the example of the highly pro-cyclical and market-based nature of the system to point out the **limited output legitimacy as well as its limitation of policy space for developing countries**. Authors suggest that the major function of an effective international financial architecture should be **to improve the input-side governance of the system and give developing countries sufficient representation to reflect their growing role in the world economy, while more attention should be paid to avoiding policy capture by private interests**. Indeed, the input-side influence on the design of the international financial architecture of the very private financial interests which stood most to benefit from the facilitation of cross-border market integration and activity is today directly associated with the causes of the crisis.

**The volume argues that global financial governance should strike the appropriate and politically sustainable balance between private and public forms of authority, which should include the interests of emerging markets and low-income countries**. Indeed, the general message of the volume is to **encourage more heterogeneous forums of discussion,** which would at least attempt to realize some degree of deliberative equality and would constitute a reasonable first step towards achieving a more inclusive, socially aware, and progressive system of global financial governance. The output-side of financial regulation would thereby be improved (more efficient because more appropriate), as well as its input-side (legitimacy due to its policy makers).

In a nutshell, by **mainly focusing on the input-side and out-put side of global financial governance**, **the volume encourages enhancing legitimacy on both sides in order to have both effective and well-accepted standards**. As Geoffrey R. D. Underhill and Xiaoke Zhang underscore, "legitimacy could be substantially enhanced through better and broader representation based on a range of principles, thus increasing the likelihood of embedding a more acceptable spectrum of norms in global financial governance. (…) in order for the reform agenda to become more legitimate and therefore more achievable, developing countries and broader publics in the developed world will have to be given a major say in the setting agenda" (p.301).

The first contribution of the volume is provided by Randall Germain ("***Financial governance in historical perspective: lessons from the 1920's***") who suggests putting financial governance[1] in historical perspective as a method for performing historical comparison between the past and the present. He provides data on financial governance from the interwar years (1920-1930). His main argument is that, because financial governance is defined by a national/international tradeoff[2], markets need, and have always needed, careful government oversight to operate; this oversight simultaneously needs to be supported by an international infrastructure. "Financial governance works best when robust international institutions support strong national authorities" (p.27). Whether in the 1920's or today, states require powerful and active international institutions to legitimately govern international financial markets.

Germain describes, with Braudel, how finance was traditionally governed by national institutions, before financial institutions adapted themselves to the imperial ambitions of the political world while coping with powerful nation states and centralized national economies. Yet, swiftly, the "*Haute finance*" (Rothschild, Lazard Frères, Morgan) and the dominance of London Based private financial institutions over global flows of capital, provided for the basis of global governance with their own norms, best practices and world credit practices. Therefore, faced with the high degree of centralization in the global financial system (central banks etc.), **their gentlemanly codes of conduct led to the determination of public goods**

[1] The author defines it as "publicly sanctioned decisions-making directed towards establishing the framework of rules by which and through which financial institutions undertake and organize financial transactions within and across borders". P. 27

[2] "The balance that government must strike between direct national accountability and internationalized competencies is determined by the distribution of benefits they receive and the costs associated with supporting internationalized governance mechanisms". P.27

**by private interests.**

In order to cope with such imbalance, states increased control over their economies (currency manipulation, capital controls, trade etc.), which required international cooperation with new emerging institutions to address issues associated with cooperation between states. At the national level, states started managing their public debt through monetary policy (allowing for tighter control on the activities of private sector financial institutions), through central banks (required to establish modern standards of financial governance), and through regulatory agencies.
At the international level, Germain identifies several first steps towards the emergence of a genuinely international system of financial governance. It was the beginning of multilateralism, used in order to recalibrate the calculated costs associated with the trade-offs between national and international pressures. First, the involvement of public authorities in the international organization of credit led to the creation of the Bank of International Settlements (BIS) in 1930. Moreover, the Agent General for Reparations payments (in order to reconcile war debts and reparations with postwar economic and political realities) is deemed by Germain an important milestone "not only in assembling the required machinery to make international transactions workable, but also in establishing the principle that the vulnerable or weak have an important stake in the construction of the apparatus of decision-making"(p. 35). **Therefore, already at the time, there was an admission that cooperation requires an international institutional infrastructure beyond what markets could provide**. And although states' efforts to resolve the conundrum of inter-allied wartime debts and reparations ultimately failed, they provided much of the basis for the subsequent Bretton Woods negotiations.

When comparing the interwar period with the 2008 crisis period, the author first notes that international cooperation has by far proven most effective in the management of the current crisis that in the interwar period: lessons were learned. Moreover, Germain suggests that from a political point of view, **both periods witnessed tremendous changes in the nature of the State's involvement in economy and important changes in the balance of power**. Moreover, in both periods, **financial governance occurred in a fragmented and decentralized international political environment.** Further, a comparison may be made with the powerful nature of the global pressures driving financial governance: capital mobility**, privatizations, deregulation and securitization**, a system that Helleiner and Pagrilari will later call in the volume "standards-surveillance-compliance regime". Such key pressures and drivers explained the need for international efforts to improve financial governance.

Yet both periods depict the worrying reluctance of States to support and extend the international infrastructures that support domestic initiatives to govern financial networks, even though sustainable financial governance requires balancing national and international imperatives. The two decades preceding the credit crisis were characterized by an attempt to re-embed liberalism, a period during which there was little room for national policy objectives that might be at odds with a global governing consensus. "In short, **global cooperation ahead of the credit crisis was no longer a complement to national policy-making**, safeguarding the efficacy of the latter — **it was a substitute, with national authorities relegated to implementing a globally agreed 'best practice'" (p.39)**.

Germain therefore worries that, in a context where priority is put on capital mobility and thirst for private gain, states have a predisposition to cede authority to independent central banks and to parcel out the regulatory patchwork to statutorily independent organizations and committees, which **risks undercutting the very political support they will need to reassert public control over global financial networks.** On the contrary, international cooperation needs to accommodate legitimate national concerns, and requires that conceptual frameworks and institutions preserve international financial openness while enabling governments to find national answers to painful reductions of public debt.

Germain concludes that, based on such historical comparison, **financial governance has been necessarily global in scope and national in execution. Therefore, liberalism demands a robust global public infrastructure that works to support national goals**. Indeed, "a historical perspective provides the key insight that strong national states buttressed by strong and well-embedded international institutions have historically been the most viable means of creating effective, efficient and legitimate governance mechanisms" (p.41).

Eric Helleiner and Stefano Pagliari's contribution, "***Between the storms: patters in global financial governance, 2001-2007***", underscores how states are less eager to change financial governance in periods of calm (e.g. 2001-2007) rather than in period of turmoil (e.g. 1994-2001), since states would rather react to economic phenomena rather than prevent them. The authors recall this trend because when several crises in the 1990's occurred in emerging countries, (Mexico, Argentina, East Asia), the G7 launched a set of ambitious regulatory reforms to create a **"new financial architecture"** (**NIFA**). However, the latter was first weakened by the subsequent **period of calm (2001-2007) which undermined the urgency of the reform and scaled back the level of states' ambition**, and second by **the reaction of emerging countries to the 1990's crisis, which differed from the G7's**. Therefore, **the pre-2008 crisis regulatory environment was made up of an "incoherent system of global financial governance, with public authorities in different parts of the world working in different directions" (p.43).**

Helleiner and Pagliari suggest that the G7 reaction to 1990's crisis in emerging countries was supposedly disoriented for two reasons: first because it blamed the regulatory framework of emerging countries (whereas the 2008 crisis came from Wall Street), and second because it adopted a market-based form of governance, mainly privileging soft law (standards, codes of conduct etc.) made up by private actors. Indeed, after the 1994-2001 crises, the G7 urged emerging countries to adopt Western Standards in terms of transparency and supervisory systems by formulating and disseminating a common set of international best practices, standards, and codes. Whereas the first standards were mainly macroeconomic (in response to Mexico's excessive borrowing) in cooperation with the IMF, the G7 expanded its agenda to microeconomic factors (such as prudential requirements). **Western countries therefore formulated standards for the entire world on banking, securities, accounting, auditing, corporate governance, while also introducing a new 'Financial sector Assessment Programme**" (FSAP) and compiling "Reports on the Observance of Standards and Codes" (ROSCs). A 'standards-surveillance-compliance' regime was therefore put in place by the G7[3], along with the Financial Stability Forum[4] to rectify the lack of coordination between regulatory agencies, central banks and treasuries. Moreover, the G7 not only blamed emerging markets' lack of regulation for the 1990's crisis, but also western countries' own rescue packages (via the IMF) as it appeared to have created 'moral hazard' at the international

[3] Which became the G20 when the G20 searched to strengthen the legitimacy of the NIFA by reaching out to emerging countries' officials. The membership of the BIS was also extended in 1996 to 55 members.
[4] Replaced by the Financial Stability Board by the G20 in 2009.

level[5].

But the apparent calm of the 2001-2007 periods lessened the priority the G7's had given to the NIFA, and other issues such as money laundering or terrorist financing were preferred. Moreover, whereas the IMF, through Anne Krueger, suggested a new IMF-led Sovereign Debt Restructuring Mechanism (SDRM) in 2001, the latter was rejected in 2003 by G7 policy makers which deemed it too bureaucratic, as opposed to a more market oriented Collective action clause approach to debt restructuring, which soon became a market norm. Other alternatives to the SDRM were put forth by private institutions (i.e. the Institute of International Finance) such as private sector voluntary codes of conduct to govern debt restructuring processes, designed to influence the behavior of both investors and debtor governments with respect to information sharing and transparency. Other codes of best practices were encouraged by the G7 and the FSF, such as those regarding hedge funds, for which the FSF repeatedly refrained from recommending direct regulation. The same reticence was applied to accounting and auditing standards, elaborated by private groups such as the International Accounting Standards Board (IASB) and the International Auditing and Assurance Standards Boards (IAASB). As for prudential standards set by the Basel Committee, requiring that banks hold capital equal to at least 8% of their risk exposure, they allowed the most sophisticated financial institutions to use their own international models and databases to self-assess their risk exposure. Basel standards also encouraged the use of credit rating agencies to assess the risk of less sophisticated financial institutions. "**This was representative of a broader trend which culminated in this period of shifting part of the responsibility for regulating and monitoring markets from the hands of regulators into the hands of private investors themselves**" (p.48).

Such behavior denoted a **dramatic shift in power in the global financial realm away from States.** Yet, one must understand that **States also played a role** in encouraging this trend, since for example the G7 triggered the emergence of market-based governance mechanisms **by delegating regulatory functions.** One of the reasons of this shift of regulatory authority to the private sector is 'policy capture' (or regulatory capture). Indeed, "public authorities found market-based governance mechanisms to be attractive tools to help them to 'walk the fine line' between stability and competitiveness' (the regulators' dilemma). At the time, **policy makers deemed that markets were best at understanding and pricing risk while government intervention was usually inefficient and distorting.**

As for emerging countries' reaction to the 1994-2001 periods, they did not understand these crises as domestic regulation's failure but rather as a consequence of crony capitalism. The IMF's intervention was unwelcome and the NIFA agenda and its "one-size fits-all" best practices did not content such countries with different traditions from the West's, and during whose elaboration they were hardly heard. In reaction to these G7 initiatives, many emerging countries took steps to boost their policy autonomy: **accumulation of foreign exchange reserves** (which contributed to the build up of global imbalances and feeding the bubble mounting in the American economy through the sustained inflow of cheap credit) or **regional agreement (such as the ASEAN**'s Chiang Mai Initiative) **to protect regions from external influences** such as the IMF. In **this view the NIFA encouraged regionalism and decentralizing trends in global financial governance** (e.g. Asian countries even considered creating an "Asian Basel").

[5] Whereas 50 billion dollars were awarded to Mexico, no bailout was awarded to foreign investors during the Argentine Crisis.

In a nutshell, the 2001-2007 periods saw Western and emerging countries working in two separate directions, creating an incoherent system of global financial governance. The NIFA had failed because it had deemed that the crises of the 1990s were rooted in emerging countries' regulatory systems, encouraged best practices which were not at all well implemented even in Western countries, and reforms decided upon in 1990 were never fully implemented. In the author's view "these differences make the crisis a turning point in the evolution of global financial governance, opening a different cycle from the one that emerged from the crises of the 1990s" (p.55). Moreover, **private actors such as private banks (and their flawed application of Basel II), credit rating agencies (and their conflicts of interest), and hedge funds (self-regulated), suddenly appeared undeserving of trust.**

In other words, **when the illusion of financial stability ended in 2007, the more financial issues became politicized and the "shadow of the state quickly loomed much larger on market-based governance mechanisms, and regulators did not hesitate to assume regulatory roles that had previously been delegated to the markets"** (p.49). Regulators finally admitted that markets could not be left to self-regulate. In this view, the new cycle in global financial governance is much less likely to rely on market-based forms of governance as described in Helleiner and Pagliari's paper. For example, the G20 already reformed the IMF twice in two years (mandate, scope, voting representation, budget) and other key institutions such as **IOSCO, FSB, and the Basel Committee also expanded their membership to include systematically important emerging countries**. The authors therefore seem confident that, although it is **too soon to know how the decentralizing trends in global financial governance and the relation between private markets and public authorities will turn out, the era described in their chapter, and which fostered such trends, has ended**.

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