GLOBAL FINANCIAL GOVERNANCE: 'SOFT' LAW AND NEOLIBERAL DOMINATION

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Introduction

The global financial sector in the 1980s and early 90s was marked by the neoliberal policies of liberalization and deregulation. Many countries, both developed and developing, dismantled the earlier restrictions on their both domestic financial sectors and external capital accounts, thus allowing freer mobility of capital. Since the mid-1990s, however, the emphasis has shifted to the creation of new international financial regulations and international harmonization in major areas of financial prudential regulations. This agenda came to be known as the reform of the global financial architecture. The frequent outbreak of major financial market crises mostly originating in the emerging market countries (EMCs) and increased instabilities in global financial markets in the wake of financial liberalization and globalization were mainly responsible for the shift in international official attention.

The new global financial architecture has four major features. First, it puts the emphasis on the micro-prudential regulation of financial markets. Prudential regulation seeks to ensure the basic safety and soundness of financial firms through minimum requirements or best practice standards such as reserve or capital adequacy requirements. The new international financial regulations are pro-market, as opposed to market-restricting, in nature. They aim to sustain the liberalized global financial system and free cross-border movement of capital. They differ fundamentally from the Bretton Woods era macro-regulation of financial markets through market-restricting measures such as controls on cross-border movement of capital, restrictions on the type of financial activities firms can engage in, and other types of direct state interventions. Thus, the recent emphasis on building an international institutional framework for global finance does not mean, in any meaningful way, a shift away from the dominant economic policies of neoliberalism. The official reform of the global financial architecture is focused on the objectives of making global financial markets more stable and efficient. The objectives of social justice and equity, which may require direct intervention in the functioning of financial markets, are excluded.

Second, the new global financial architecture primarily relies on soft law in the form of international standards and codes rather than legally binding treaties. One reason for this is the fact national regulatory systems, which have developed over long stretches of time, and thus reflect their national political and economic settings, continue to differ from each other. This situation poses obstacles to the creation of detailed multilateral treaties. Another factor that favours the soft law approach over binding multilateral treaties is rapid product and process innovations in financial markets. Multilateral treaties are typically a product of negotiations in international organizations. This process is usually onerous and costly. But such difficulties national regulatory authorities may encounter when they attempt to negotiate a multilateral treaty for financial-sector regulation does not satisfactorily explain the increased role of soft law in global financial governance. As

[1] An earlier version of this paper was presented at the International Studies Association's 2005 Annual Meeting in Hawaii.

Cutler (2003: 23) rightly points out, hard and soft law "embody different power relations", and the increased significance of soft law has important political implications. Although it is more time consuming and more expensive to achieve hard law in the form of binding international treaties, once it is achieved, hard law ensures a certain degree of transparency and predictability. It is also more difficult for stronger parties to renege on commitments agreed in formal international treaties. While it is less onerous and cheaper to achieve, soft law leaves ample room for, especially for stronger parties, for discretionary application, and it is also easier to breach. For all these reasons, argues Cutler, less powerful developing countries tend to prefer hard law. Soft law in the form of standards and codes lends itself more easily to insulation from democratic politics. Many of the international institutions responsible for developing financial standards and codes are composed of a narrow circle of finance officials and technocrats. These officials tend to share a frame of thought, and have frequent contacts, with managers of private financial institutions. They are at the same time well insulated from popular political pressures. Some of the international standard setting agencies, such as the Basel Committee on Banking Supervision, operate in great secrecy. There are no mechanisms for the public to monitor their policy processes (Porter, 2001: 95). They thus easily escape public scrutiny as well as monitoring by national legislative organs. Furthermore, some of the major international standard setting bodies, such as the Basel-based committees, are restricted to the developed countries with major financial centres, excluding developing countries. In those standard-setting agencies which include developing countries among their members, such as the International Association of Securities Commissions, major developed countries clearly predominate in the policy process.

Third, complementing the increased significance of the standards and codes approach in global financial governance is the creation of less formal or informal institutions which are limited to a select group of countries in membership. Two such institutions are the Financial Stability Forum and the Group of 20 (G-20). As will be explained later, they were both created in 1999. The architects of the two institutions were G-7 finance ministers, who also handpicked their members. Unlike formal, multilateral organizations, such informal institutions usually lack transparent, consistent rules governing representation and participation. This situation works against the weak and enhances the power of the strong.

Fourth, the primary target of many of the new international standards and codes in the area of global finance is the EMCs. The purpose of these standards and codes is to raise the quality of the EMCs' regimes of financial regulation, thereby making them safer for the global financial system as a whole. This strategy is premised on the view, which is dominant in the international financial institutions, among government officials of the major Western countries as well as large private financial institutions, that the main cause of the recent financial crises was the poor quality of the EMCs' regulatory and supervisory systems and their financial sector infrastructures. International standards and codes involve major new obligations for the EMCs. However, despite the G-7's recent efforts to better include the EMCs in the decision-making organs of the global financial system, such standards and codes are made without adequate representation and participation of the EMCs. Furthermore, as these standards and codes are modeled on the institutions and practices prevailing in the developed countries, they fail to address the specific problems and needs of the less developed countries.

INTERNATIONAL HARMONIZATION AND SOFT LAW

A major problem currently faced in the area of financial regulation is the increasing disjunction between the locus of regulatory authority and the object of regulations. While financial regulatory powers have historically concentrated in the hands of national authorities and, financial markets have become global. Transnational financial conglomerates that combine a wide range of financial activities are rapidly proliferating, and an increasing number of financial firms, including banks, securities firms, investment funds and hedge funds, operate simultaneously in many different political jurisdictions. This situation is a source of major concern for national regulatory authorities because of the availability of greater opportunities for private financial institutions to escape or evade national prudential regulation and supervision in globalized financial markets. There is a heightened risk of global financial instability and crisis that can arise from regulatory arbitrage by financial firms and a possible regulatory competition in laxity by national authorities who are worried about their global financial market shares. It is also harder to protect legitimate market participants against financial fraud and to prevent money laundering and other financial crimes when regulatory and supervisory role is divided among a large number of national authorities while financial activities are globalized. The international official response that has developed to solve this problem hinges on minimum harmonization of national regulatory and supervisory regimes. It also promotes increased international cooperation and coordination among national financial authorities. It is important to point out that regulatory harmonization in international finance serves a dual purpose: On the one hand, it is aimed at reducing global financial instabilities arising from regulatory arbitrage and weak regulations. On the other hand, harmonization of banking, securities and accounting regulations facilitates further global integration of capital markets and cross-border mobility of capital.

The soft law approach has emerged as the dominant approach to promoting regulatory harmonization in global finance. This approach differs from traditional treaty making, which is the dominant mode of international regulation in other major areas of the international economy, especially trade. The soft law approach to governing international/transnational financial activities rests on internationally agreed but legally non-binding standards and codes. Such standards and codes are declarations of guidelines, rules and principles that define best practice or good practices in a particular area. Although they lack legal standing at the international level, they are often transformed into laws and enforceable formal regulations at the national level. The adoption and observance of international financial standards and codes by national governments are predicated on two different types of incentives: market-induced discipline and official incentives. Market discipline is exerted through the price mechanism. It operates through international investors' factoring into their lending and investment decisions of a country's observance of relevant international standards. Countries that fail to observe certain minimum standards will presumably suffer lower credit ratings and higher risk premiums. The international official bodies responsible for financial standards and codes attach major significance to market discipline as part of their strategy to foster compliance. This strategy includes various efforts to raise market participants' awareness of international standards and codes, disseminate information on countries' observance of international standards, and encourage international investors to factor that information into their risk assessments, pricing, and other investment and lending decisions. According to some recent surveys, however, thus far, market participants are unaware of many of the existing standards; when they know about them, they place economic and political factors above the consideration of the quality of a country's financial regulations (FSF, Mar. 2000). Besides their reliance on the market discipline, the international standard setting bodies employ a number of official incentives. The main official incentives used are peer pressure, name and shame, surveillance and financial incentives (Giannini, 2002: 148). Peer pressure is more likely to be effective when participants are comparable in power and influence, and they share values and conceptual frameworks. In recent years, the international standard setting agencies have been more willing to use the old practice of name and shame against jurisdictions that refuse to comply with international standards and codes. At the receiving end of this somewhat tougher strategy have mostly been small and weak countries. The major examples are the Financial Action Task Force's list of non-cooperating states regarding money laundering; the OECD's list of jurisdictions regarded as tax havens; and the Financial Stability Forum's classification of offshore financial centres according to the quality of their financial regulatory and supervisory systems. It is not likely that international financial institutions or standard setting agencies will use this strategy against major states.

The third type of official incentives that plays an important role in the soft law approach is the surveillance activities of the international financial institutions (IFIs). The most important in this regard is the IMF's and World Bank's surveillance of member states' economic policies. The IMF's surveillance role has recently expanded beyond its traditional domain of macro-economy; it now includes assessments of member countries' financial sectors and prudential regulations. Thus, since the late 1990s, for the first time in its history, the IMF has taken an important role in the area of financial prudential regulation, which is not part of its original activity. The increased surveillance role of the IMF matters most with respect to the EMCs, which the governments of the G-7 and the officials of the IFIs see as the main source of global financial instability and crises (see G-7, 1999). The IMF's powers over the EMCs derive from both financial sanctions and incentives it can apply. As part of their new surveillance role with respect to the financial sector, in 1999, the IMF and the World Bank jointly introduced a new tool called "the Financial Sector Assessment Program" (FSAP). Under this program, a team from the two organizations carries out an in-depth analysis of the strengths and vulnerabilities of a country's financial system and its compliance with a number of key international standards and codes. Countries participate in the program on a voluntary basis, and it is only with the consent of the participating country that the assessments can be published. The IMF uses the FSAP results to prepare its Financial Sector Stability Assessment (FSSA) for the participating country. The FSSA is then used within the context of the concerned country's Article 4 consultation and in the preparation of the Fund's programs. The FSAP also constitutes the World Bank's Financial Sector Assessment (FSA) program whose purpose is similar to that of the IMF's FSSA. Under the FSAP, the IMF and the World Bank jointly undertake 17-19 initial assessments each year, and update a number of earlier assessments. As of the end of 2004, a total of about 100 countries participated or were about to participate in the program (FSF, Sept. 2004: 9).

In 1999, the IMF and the World Bank launched another surveillance program which focuses on international standards and codes relevant to global financial stability. The program is called the Reports on the Observance of Standards and Codes (ROSCs). Preparation of the reports is carried out on a modular basis. The purpose of the program is to assess the extent to which member countries observe selected international standards and codes.[2] Participation in the program, as well as publication of the reports, is voluntary. However, there is strong pressure on the EMCs, which may need the financial assistance of the IMF and the World Bank, to participate. By the end of March 2004, a total of 528 ROSC modules for 107 countries had been completed; the publication rate was 76% (FSF, Sept. 2004: 10). It should be noted that the IFIs expect that publication of such assessments will help strengthen the market discipline as well, hence making compliance with relevant standards more attractive.

A more direct official strategy for promoting compliance with international standards and codes is to link the provision of financial incentives to governments' observance of selected standards. Over the last 10 or 15 years, the IMF and the World Bank both have used conditionality to carry out far reaching financial-sector reforms in countries seeking assistance. In recent IMF programs, institutional and financial-sector reform received more attention than trade and exchange rate liberalization (Gomel, 2002: 170). A recent review carried out by the IMF staff reveals that about a quarter of program conditions are concerned with the financial system (Giannini, 2002: 149). Conditions regarding bank supervision and regulation were included in 79% and 71% respectively of the World Bank's financial sector adjustment loans in the 1990s (Brownbridge, 2002: 306). The scope of IMF conditionality has in fact expanded significantly during the same period. The Fund has recently started integrating relevant standards and codes in its loan programs. Furthermore, access to the IMF's new credit facility called Contingent Credit Line (CCL) is conditional on a country's adherence to certain international standards regarded as central to financial system stability.[3] A main problem with this strategy is the fact that it can be applied only in the case of countries that request financial assistance from the Fund or the World Bank. The IFIs cannot use conditionality to enforce international standards and codes vis-à-vis countries that do not need their financial help.

SHIFT TO INFORMAL FORAS

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[2] There are 12 standards and codes included in the ROSC program. They are in the areas of data dissemination, fiscal transparency, transparency in monetary and financial policies, banking supervision, securities regulation, insurance supervision, payments and settlements, corporate governance, accounting and auditing, insolvency and creditor rights, anti-money laundering and combating the financing of terrorism. These are the same standards that the Financial Stability Forum has endorsed as key to the stability of the global financial system. They will be discussed later in the paper.

[3] The CCL was created in 1999. Its purpose is to provide member countries facing the threat of financial contagion timely access to large amounts of funding under strict predetermined conditions (see IMF, 1999).

While the soft law approach has emerged as the dominant approach to international financial regulation, there has been a parallel shift from formal governmental organizations to less formal forums in decision-making over the past decade. There has also been an increased role of various technical and self-regulatory professional bodies in the creation and dissemination of international standards and codes during the last two decades or so. The most important informal or less formal forums are the G-7, more specifically the G-7 finance ministers' regular meetings, the G-20, and the Financial Stability Forum. The major technical and professional standard setting agencies include the Basel Committee on Banking Supervision (BCBS); International Organization of Securities Commissions (IOSCO); International Association of Insurance Supervisors (IAIS); International Accounting Standards Board (IASB); and International Federation of Accountants (IFAC). The last two agencies are entirely private-sector bodies, while in some other organizations, such as the IOSCO, relevant private professional associations are also represented.

In 1999, two major official forums were created as part of the reform of the global financial architecture. They were the Financial Stability Forum (FSF) and the Group of 20 (G-20).[4] They were both the work of G-7 finance ministers.The standards and codes approach gained further momentum and official approval with the establishment of the two forums. The FSF adopted the standards and codes approach as its main strategy for promoting the stability of the global financial system. The purpose of the creation of the G-20, which is a grouping of the G-7 and major emerging market countries, was to ensure the cooperation of the EMCs in the adoption and implementation of international standards and codes relevant to global financial stability.

Financial Stability Forum

The Financial Stability Forum was set up at the recommendation of a G-7 working group headed by Bundesbank President Hans Tietmeyer (see Tietmeyer, 1999). G-7 finance ministers had mandated Tietmeyer to develop recommendations for new arrangements to enhance cooperation and coordination among key national and international supervisory agencies and international financial institutions so as to foster stability in the international financial system (G-7 Finance Ministers, Oct. 1998). The G-7's this move came in response to a series of financial market crises occurring in emerging market economies, the latest of which was the Asian crisis. The Forum's inaugural meeting took place in April 1999.

The Financial Stability Forum is the only international body with the specific mandate to improve coordination among the various authorities responsible for financial regulation and supervision, including banking, securities market and insurance. Its main role is to enhance cooperation and coordination among the national financial and monetary authorities from countries with major financial centres, the major international financial institutions and international supervisory and regulatory agencies. Its principal objective

[4] They were preceded by the ad-hoc G-22, better known as the Willard Group. It was composed of finance ministers and central bank governors of the G-7, Australia, and fourteen EMCs and transition economies. It was put together in the immediate aftermath of the Asian crisis to discuss the reform of the global financial system.

is to promote stability and reduce systemic vulnerabilities in the global financial system through strengthened global financial market surveillance and supervision.[5]

The FSF brings together under one roof the main international financial institutions and regulatory agencies. It, thus, to some extent, resolves the problem of functional fragmentation of international financial market regulation among different regulatory agencies. It is composed of national authorities responsible for financial and monetary affairs (finance ministry or treasury, central bank and supervisory agency) and senior officials of the IFIs (IMF, World Bank, BIS and OECD), international regulatory and supervisory bodies (IOSCO, the Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS)), and committees of central bank experts (Committee on the Global Financial Stability (CGFS), Committee on Payment and Settlement Systems (CPSS)).[6] The FSF has a small secretariat located at the BIS in Basel, where the BCBS and several other committees of central bank officials of the G-10 are also located.

The Financial Stability Forum's national membership was initially limited to the G-7 countries, as recommended in the Tietmeyer report.[7] The highly exclusive composition of the new forum caused criticisms and protests from the EMCs as well as some of the excluded developed countries such as Australia. To address the problem of the absence of non-G-7 representation in an international policy forum that was created with the explicit purpose of enhancing international cooperation and coordination in matters affecting the stability of the global financial system, the G-7 agreed to broaden the forum's membership 'to include significant financial centres in a format that provides for effective dialogue' (G-7 Finance Ministers, 1999). Before its second meeting in September 1999, the FSF expanded to include Australia, the Netherlands, Hong Kong and Singapore (FSF, 1999). However, the EMCs are still excluded from the Forum's membership. The very limited country membership of the Forum reflects the G-7's reluctance to share decision-making power in the area of financial matters which they clearly dominate. In order somewhat to rectify its weakness in terms of representativeness and participation as well as to make its work more legitimate, the major EMCs are regularly invited to participate in its ad hoc working groups. However, decisions with respect to which EMCs are allowed to participate in what working groups are at the discretion of the FSF's members. Such decisions are not governed by pre-established, clear rules and procedures. The objective of limiting the size and diversity of

[5] See the FSF's web page 'About the FSF', http://www.fsforum.org/About/Home.html.

[6] 25 national representatives (three representatives from each of the G-7 countries; one representative each from Australia, Hong Kong, the Netherlands, and Singapore); 6 senior officials from the IFIs (IMF, 2; the World Bank, 2; the BIS, 2; OECD, 1); 6 officials from the international regulatory and supervisory bodies (BCBS, 2; IOSCO, 2; IAIS, 2); 2 officials from the committees of central bank experts (CGFS, 1; CPSS, 1).

[7] The Tietmeyer Report suggested that 'The Forum should be limited to a size that permits an effective exchange of views and the achievement of action-oriented results within a reasonable time frame'. It proposed that the forum should initially include only the G-7's financial authorities besides representatives of the IFIs and major international financial regulatory and supervisory bodies. The report also noted that the forum's membership could overtime be broadened to include 'a small number of additional (i.e. nonG-7) national authorities' (Tietmeyer, 1999).

the Forum's membership in order to facilitate 'the achievement of action-oriented results within a reasonable time frame', as the Tietmeyer report recommended, has thus far prevailed over the concern about the representativeness of its composition. Partly to reconcile the two concerns, soon after the creation of the FSF, the G-7 finance ministers took another initiative in establishing a second and more inclusive international policy forum on global financial and monetary matters, that is, the G-20, as will be explained later.

The FSF's main activities thus far can be grouped into two categories: standard setting; and assessing vulnerabilities of the global financial system and identifying solutions for such vulnerabilities. The main role of the FSF in the area of standard setting is to compile, endorse and disseminate standards and codes relevant to global financial stability which are agreed by the various international standard setting bodies. This involves evaluating such standards and codes and identifying those that deserve priority implementation. Soon after its creation, the FSF compiled a Compendium of Standards. As of February 2005, the Compendium included total 76 standards. These were classified into three major areas: macroeconomic policy and data transparency; institutional and market infrastructure; financial regulation and supervision[8]. Of this list, the FSF has identified twelve sets of standards as key for sound financial systems and that therefore should be given higher priority in implementation.

Although the FSF does not have enforcement powers, it took an important initiative with respect to the observance of the key standards and codes. This initiative is concerned with the offshore financial centres' regulatory and supervisory arrangements. The FSF's continuing interest in the OFCs stems from the fact that the increased role of such unregulated or lightly regulated financial centres in the global financial markets poses major risks to the stability of the global financial system as a whole. They also provide opportunities for tax evasion and make it easier for businesses to escape national regulations. In 2000, the Forum published an important report on the OFCs. The report included a list of those jurisdictions considered an offshore financial centre and graded them according to the quality of their regulatory and supervisory systems. The FSF also asked the IMF to introduce a financial sector assessment program for the OFCs. The purpose was to encourage the OFCs to strengthen their regulatory and supervisory arrangements in accordance with relevant international standards and codes. The FSF's name and shame tactic initially caused uproar. But many of the listed OFCs also soon agreed to participate in the IMF's assessment program. Almost all of the 42 OFCs identified in the FSF's report had participated in the program by the end of 2004. According to the FSF's most recent review based on the IMF assessments, there have been significant reforms in the OFCs, especially the wealthier ones, as result of the international pressure (FSF, Apr. 2004). The FSF continues to take a close interest in the issue.

G-20

As I pointed out earlier, a principal objective of the new international standards and codes relevant to the stability of the liberalized global financial system is to reform the EMC's

[8] The Compendium is available on the FSF's website (www.fsforum.org).

regulatory and supervisory institutions in accordance with the standards that exist in the developed countries. That is because according to the IFIs and the G-7 officials the EMC's poor prudential arrangements are a major threat to the stability and effectiveness of global financial markets.[9] There is also the increased risk that a financial crisis can be rapidly transmitted across territorial borders as a result of the global integration of capital markets. As a result, the quality of prudential regulatory and supervisory regimes in the EMCs has become a matter of concern for the developed countries as well as the IFIs. At the Lyon summit in 1996, the G-7 leaders designated financial prudential regulation in EMCs as a priority area that required special attention as part of the international efforts to strengthen the global financial system. They also called on the IFIs to work towards creating effective supervisory structures in the EMCs (G-7, 1996).[10] The G-7 finance ministers' subsequent plans to strengthen the international financial architecture also included this issue as a priority area (G-7 Finance Ministers, 1997). The EMCs are thus asked to take on new obligations and bear much of the burden of the reform of the international financial architecture which seeks to maintain the neoliberal system of free capital mobility. Thus, at least to some extent, the EMCs had to be included in the decision-making process on the governance of global finance in order to increase the chances that they would agree to reform their domestic regulatory institutions on the basis of international standards and codes. Implementation of international standards requires domestic political commitment. That is why G-7 officials and the IFIs are putting a strong emphasis on promoting 'country ownership'. They also understand that an effective way of fostering ownership is to allow the major EMCs that are asked to take responsibility for implementing reforms to have at least some degree of representation and participation in the decision-making process (see FSF, Mar. 2000: 9-10, 22; Martin, 2001). The inclusion of the EMCs in this process came in the form of the G-20.

The G-20 was formally established at the G-7 finance ministers' meeting in September 1999 and held its inaugural meeting in December of the same year. It is comprised of finance ministers and central bank governors from Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the G-7, the EU Presidency (if not a G-7 member), the European Central Bank, and senior representatives of the IMF and the World Bank. The G-20 considers itself not a formal decision-making body but 'a mechanism for informal dialogue… on key economic and financial policy issues among systemically significant economies' (G-20, 1999a). It is thus modelled after the G-7's informal discussions.[11] It gathers once a year at the level of finance ministers and central bank governors, and twice at the level of deputies.

The G-20 has not become an influential body. Its last annual meeting at the ministerial level in November 2004 hardly attracted any attention even from the media. The scope and specific items of its agenda to date have been closely aligned with the FSF's agenda.

[9]See, e.g., the following documents or press releases, G-7 Finance Ministers (May 1998); G-7 (1999); G-20 (1999b; 2000); FSF (Apr. 2001: 1-2).

[10] In response to the G-7's call, the G-10 central bank governors soon created a working group, the Working Party on Financial Stability in Emerging Market Economies, which included representatives from EMCs to determine what needed to be done to strengthen EMCs' financial systems.

[11] Unlike the G-7, however, the G-20 is headed by a chairperson appointed for a two-year term; it also includes the IFIs among its regular members.

In conformity with its primary mandate of enhancing the stability of the global financial system, the G-20's work has focused on reducing the EMCs' vulnerability to financial crises. This effort has revolved around strengthening the EMCs' prudential and supervisory regulations; improving transparency in economic policy; and promoting their observance of relevant international standards and codes.[12] However, the EMC members of the group have been pushing for the expansion of the group's agenda to include their specific concerns, such as better trade access to developed countries' markets, development financing and a more equitable distribution of the benefits of globalization among countries. The G-20's last meeting, which took place in Berlin in November 2004, produced an "accord for sustained growth" besides discussions on global financial and monetary matters (see G-20, 2004).

INTERNATIONAL STANDARDS AND CODES

The international standards and codes the EMCs are asked to adopt cover a wide range of economic and financial sectors. The twelve sets of standards that the FSF identified as deserving high priority in implementation and that constitute the basis of the IMF's and World Bank's new surveillance programs require major institutional changes in the EMCs. They go beyond specific policy measures and require a restructuring of their state apparatuses and policy-making process, as well as their domestic financial systems so as to make them safer not only for their own economies but also for the entire global financial system. Two of the standards are related to transparency in financial and fiscal policy. They are specifically directed at the EMCs. Three standards are concerned with banking supervision, securities regulation, and insurance supervision. Of these, the banking sector has received the most attention in the case of the EMCs. This is due to the fact that banks continue to dominate the financial systems of most EMCs. The rest of the key standards are in those areas that have a direct bearing on financial prudential regulation, as well as global integration of capital markets. They include insolvency and creditor rights regime, corporate governance, accounting, auditing, payments and settlement systems, and money laundering.

The governments of emerging market countries are concerned that the international standards they are asked to adopt are mostly modelled on the institutions and practices of the western developed countries. Some of them worry that these standards, many of which have been developed without developing country representation, are incompatible with their own institutions and legal systems. Therefore, they insist that compliance must be voluntary and that they should be assessed on the basis of the progress they make towards compliance rather than their absolute compliance. The worries of some developing countries run even deeper. In their view, behind the standards and codes strategy lies an insidious motive to weaken their indigenous institutions, and thereby paving the way for the MNCs to dominate their financial systems (Kenen, 2001: 129).

Since the IFIs currently put a predominant emphasis on reforming the EMCs' banking sector in accordance with relevant international standards, it is important to briefly discuss the key international standards for banking.

[12] The G-20 maintains a website (www.g20.org). The website provides an up to date account of the G-20's work, as well as an archive of materials related to its meetings.

The Basel Standards for Banking and the EMCs

Although the standards and codes approach to international harmonization in financial regulations has risen to prominence over the last decade, its origin goes back to the mid-1970s. The Basel Committee on Banking Supervision (BCBS)[13] has played a key role in the articulation of this approach. It was formed by the central bank governors of the G-10 in response to the failure of several internationally active banks in 1974.[14] The bank failures caused fears of a chain reaction in an increasingly integrated international financial market. Convinced of the urgent need for greater international cooperation and coordination among national bank supervisors established the Basel Committee. The Committee is composed of senior representatives of bank supervisory authorities and central banks from the G-10 plus Spain.[15] It is an informal organ and operates in a great deal of secrecy. The Bank for International Settlements provides the secretarial services. The Basel Committee is currently the main international agency responsible for international bank regulations despite its very limited membership. Its standards have been adopted by many national bank authorities all over the world.

In its early years, the BCBS focused on setting general principles for the division of responsibilities for bank supervision between home and host countries so that international banks would be adequately supervised.[16] It produced several non-binding agreements on these matters over the years, which it revised a number of times to take account of changing circumstances. Its crowning achievement was the Capital Adequacy Accord. In the mid-1980s, the Committee moved beyond its earlier focus on adequate supervision of internationally active banks and started to work on minimum capital standards for international banks. Two factors were influential in this move: the Third World debt crisis and the consequent deterioration of the balance books of many big multinational banks which had lento to developing countries generously in earlier years. The second factor was Japanese banks' competitive success in increasing their share of international banking. Increased competition from Japanese banks led major American banks to pressure the American government to create a level playing field at the international level. They saw Japanese banks as having an unfair advantage because of different capital adequacy regulations in Japan.

After several years of negotiations, the Basel Committee agreed the Capital Adequacy Accord in 1988. The Accord established risk-based capital requirements for international banks.[17] It required that internationally active banks must hold total capital equivalent to no less than 8% of their risk-weighted assets. The Capital Adequacy Accord was originally designed for banks in the advanced economies. It represents "the industrial country model of bank regulation" (Caprio and Honohan, 1999: 51). As part of broader reforms to their financial systems and prudential regulations, often under the structural

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[13] It was originally named the Standing Committee on Banking Regulations and Supervisory Practices.

[14] The G-10 includes Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the UK and the USA.

[15] Spain joined the Basel Committee in 2001.

[16] For the history of the Basel Committee and its activities, see Porter (1993), Kapstein (1994), and Herring and Litan (1995).

[17] The BCBS's documents are found on the BIS's website (www.bis.org).

adjustment programs of the IMF and the World Bank, many developing countries in Latin America, Asia and Africa adopted the Basel capital standards (Brownbridge, 2000: 7). The Basel Committee members' tacit threats to exclude non-complying countries' banks from their markets also played a significant role in the widespread adoption of the Basel standards (Porter, 2001: 95).

In the years since its adoption, the BCBS amended and updated the Accord several times to address its shortcomings as well as to adapt it to changing conditions as the financial markets became more complex and integrated globally. In 1999, it started to work on a new capital adequacy framework rather than to continue to refine the 1988 Accord. The Committee members concluded the new Capital Adequacy Accord, known as Basel II, in June 2004. They agreed to begin implementation in 2006 or 2007. Basel II retains the key rules of the 1988 Accord, including the requirement that banks must have a total capital of at least 8% of risk-weighted assets. It seeks to align more closely each bank's minimum capital requirement with its credit risk and to measure credit risk more accurately. It proposes two approaches to credit risk: the standard approach and the internal-ratings based approach which is an innovation of Basel II.

The Basel Committee and the IFIs are promoting adoption of the new capital adequacy standards worldwide including in developing countries. However, only a handful of developed countries participated in drafting them. Although compliance is voluntary for non-Basel committee countries, the EMCs are likely to face strong pressure from the IFIs as well as the G-7 governments and their internationally active banks concerned about a level playing field, to adhere to these standards. Furthermore, Basel II will still have major effects on the economies and financial systems of the EMCs even when they do not adopt it. Nevertheless, in designing it, the Basel Committee undertook no comprehensive study of the possible effects of the proposed accord on the EMCs and developing countries as borrowers despite the fact that international bank lending plays a significant role in their economies (Griffith-Jones et al., 2004:1-2).

A most important and possibly the most contentious feature of Basel II is its greater reliance on banks' own internal systems of risk management. It allows banks to use their internal models of risk assessment to calculate the levels of capital appropriate for their risk profiles. The role of national bank supervisors in this case is to review the bank's internal risk management system and to ensure that the bank's system is adequate to use as the basis for capital calculations. As critics of the new Accord point out, only the biggest banks have the capacity to develop and use such advanced risk management systems. Smaller and less sophisticated financial institutions have to rely on Accord's standardized approach. By using the most advanced risk assessment techniques, large multinational banks will be able to lower their minimum capital requirements and thereby their effective capital cost. This will allow them to free up funds to use for other purposes. Even in the advanced economies of the G-10 countries, smaller banking institutions (such as community banks in the USA) are concerned that the new Basel Accord gives big banks an unfair competitive advantage and that it will increase the cost of lending to small businesses which are the main clientele of smaller banking institutions (Whalen, 2004). Banking institutions in emerging market countries are even more worried that Basel II standards put them at a distinct disadvantage vis-à-vis big multinational banks based in the developed countries. Not only do many of them lack the necessary technical and knowledge capacity to take advantage of the new Accord's internal-risk based approach to capital calculation. With the implementation of Basel II procedures, they will have to raise their minimum capital (Dunkley, 2004: 2). The likely result will be higher costs of borrowing and reduced level of lending in the domestic economies of the EMCs. If the EMCs are to implement the complicated rules of Basel II successfully, their bank supervisory systems may have to undergo substantial reforms, including retraining personnel and upgrading technical expertise at a significant cost. Another aspect of the Basel Accord specifically relevant to developing countries is its failure to pay attention to micro-credit institutions which play an important role in some developing countries, and serve mainly the poor and women.

Another contentious aspect of Basel II, which also has major implications for the EMCs, is the heavy reliance of its standardized approach on credit rating agencies in determining minimum capital requirements. It not only allows the use of the credit ratings assigned by rating agencies to private companies. It also proposes the use of sovereign debt ratings by such agencies in the case of international bank lending. More specifically, it calculates the risk-weighted capital charge for short-term foreign currency loans between two banks in terms of the credit ratings assigned by rating agencies to the sovereign debt of the country where the borrowing bank is based. Sovereign debt ratings include assessments of the concerned government's economic policies. These assessments typically involve evaluating the government's compliance with neoliberal principles. As Patomäki (2001: 94) explains:

> The assessments are made on the basis of particular models and interpretations of reality and a selected set of data. What is characteristic of this framework is the domination of narrow assumptions about market efficiency, in which 'undistorted' price signals are the objective and state intervention is generally considered unhealthy. In other words, the standard financial orthodoxy reigns. Hence, *this system rewards those compliant with neoliberal ideals and rentier interests, and punishes those attempting to deviate from 'the right path'*. (Original italics)

Furthermore, subjective evaluations, which are inevitably part of credit rating, cannot be divorced from the social context in which the rating agency is located. The biggest and internationally most influential rating agencies are American, such as the Moody's and the Standard & Poor's. The past record of many such rating agencies is also questionable. For example, the performance of these agencies contributed to the severity of the Asian crisis (Mezzera et al., 2002: 137).

As pointed out earlier, partly as a result of tacit threats from the Basel Committee members, many countries, including developing countries, adopted the 1988 Capital Accord, although they were not participants in the process of drafting it. It remains to be seen to what extent the new Accord will be endorsed by such countries. The governments of two major EMCs, namely China and India, announced their decisions against implementing the Accord (Dunkley, 2004: 2).

Until the mid-1990s, the Basel Committee's work was focused on the developed countries. It did not show any special interest in the financial systems of less developed countries. Since the mid-1990s, it has expanded its activities to the EMCs. At the Lyon summit in 1996, the G-7 Heads of Government urged the Basel Committee to take initiatives with regard to improving bank supervision in the emerging markets. The product of the Committee's efforts in this regard was the Core Principles for Effective Banking Supervision which was released in 1997. Bank supervisors from a number of emerging market countries were invited to participate in the preparation of these principles.[18] The Basel Core Principles are consisted of twenty-five general principles which deal with effective banking supervision and prudential regulations. The FSF and the IFIs endorsed these principles and included them among the key international standards for sound financial systems. They are part of the IMF/World Bank's Financial Sector Assessment Program, which examines a country's observance of a number of key standards.

While it became the principal international standard-setting agency in the area of bank regulations, and the standards it develops are now intended to apply worldwide, the BCBS's membership is still limited to the exclusive club of thirteen developed countries. Although in recent years, it has actively sought to establish closer links with national bank authorities in non-member countries, it has not admitted any new members since its creation with the sole exception of the admittance of Spain in 2001.

International Standards for Policy Transparency and Data Disclosure

The G-7-led reform of the global financial architecture has placed a strong emphasis on transparency in economic policy and data disclosure. Much of the blame for the recent emerging market crises was put on the lack of policy transparency and timely, accurate data. In the aftermath of the 1995 Mexican crisis, big multinational financial institutions launched a campaign for greater data disclosure both by borrowing countries and by the international financial institutions (Orr, 2002: 206). The East Asian crisis led to further calls for timely and better information, 'as foreign investors… blamed the East Asian governments for not giving them enough information' (Stiglitz, 1998: 7). As the crisis-stricken emerging market countries were found lacking in both policy transparency and timely dissemination of accurate data, the G-7 officials and the IFIs called for greater policy and data transparency as key to the stability of the global financial system. As in the area of financial prudential regulations, the standards and codes approach was adopted as the main strategy to encourage greater transparency of the economic policy making process in the emerging market countries.

Two codes the IMF drafted became the key international standards in policy transparency in the context of the global financial reform. The first code, which the Fund adopted in April 1998, sets out good practices for transparency in fiscal policy, and the second code,

[18] The Basel Committee created the Basel Core Principles Liaison Group to include representatives from fifteen EMCs and transition economies in the preparation of the Core Principles. It also had consultations with regional bank supervisors' groups at the preparation stage.

which was released in September 1999, defines good practices for transparency in monetary and financial policies.[19]

Transparency means, in the context of the global financial reform, openness to scrutiny, clarity and predictability of rules and policy instruments, and also consistency in their application. From the viewpoint of democracy, greater transparency is a significant progressive objective. However, the purpose and the framework of thought that underlie the principle of transparency in the financial reform agenda are not actually democratic representation, and accountability of policy makers to the entire public or citizens. As is clearly revealed in the documents and reports of the international decision-making bodies responsible for the financial reform, market participants and investors are conceived as the principal constituency of the transparency principle. The framework of thought that informs this notion of transparency is the ideas of market efficiency and market discipline. That is, the view that transparency in economic policy enables market participants to make proper assessments of credit and investment risks, and contributes to the more efficient formation of market expectations. Thus, in this view, transparency promotes market efficiency and reinforces market discipline, which in turn contributes to the adoption of sound policies (see IMF, Sep. 1999a; G-7 Finance Ministers, May 1998; 1999; G-20, 1999).

One major purpose of the transparency principle is to minimize uncertainty in the policy areas that affect private investors' lending and investment risks, and the rate of return on their investments. It also aims at subjecting government policy to close surveillance by financial market agents as well as by the international financial institutions. The IMF's given justification for the Code of Good Practices on Fiscal Transparency states that 'The Code will facilitate surveillance of economic policies by country authorities, financial markets, and international institutions' (IMF, 2001). This in fact means making governments more accountable to large institutional investors in global financial markets. Accountability here implies establishing or maintaining credibility with global financial markets. Credibility requires pursuing policies that are favoured by institutional investors, for example, such monetary and fiscal policies that set price and exchange rate stability rather than employment as the overriding goal. Among the preferred policy measures today are cutting public expenditures (especially social welfare expenditures) to balance the budget, and tying monetary policy to a predetermined monetary target. In the context of liberalized global financial markets, which the global financial reform seeks to sustain, governments that fail to implement sound policies can be disciplined by a rapid outflow of highly mobile finance/money capital. In the case of a lesser deviation, they may have to pay a risk premium in interest rates. This is the main reason why governments today are overly concerned about maintaining their credibility with, or confidence of, global financial markets. Of course, not all states are equally vulnerable to pressures emanating from global financial markets; it is especially states of smaller or less developed open economies that find their policy autonomy significantly constrained by enormous financial flows.

[19] The Code of Good Practices on Fiscal Transparency (http://www.imf.org/external/np/fad/trans/code.htm); the Code of Good Practices on Transparency in Monetary and Financial Policies (http://www.imf/org/external/np/mae/mft/code/index/htm).

Some of the international standards identified as crucial to the soundness and stability of the global financial system are concerned with transparency in the private sector, such as corporate governance, accounting and auditing. In the aftermath of major corporate scandals in the USA and elsewhere and following public outcry, in recent years, there has been an increased emphasis on corporate governance and disclosure requirements for publicly traded companies. However, the growing use of highly complex financial instruments, including derivatives, makes it easier for corporations to conceal their actual financial conditions, or makes 'at least the full interpretation of the disclosed information even more difficult' (Stiglitz, 1998: 8). Furthermore, some new types of highly leveraged financial institutions, such as hedge funds, are either very lightly regulated or subject to no official regulatory oversight. This is despite the fact that in recent years, the hedge fund industry has rapidly grown. It now controls over $ 1 trillion in assets, compared with $ 50 billion in 1990, according to estimates (*The Economist*, 12 June 2004: 82). It should be noted that increased concerns over market manipulation and financial fraud led the Securities Exchange Commission (SEC) of the USA to introduce some minimum regulations for hedge funds in October 2004, such as the requirement that hedge fund managers have to register with the SEC and open their books to inspection. These regulations are expected to go into effect in 2006. There is, however, opposition, not only from hedge funds but also from within the US Congress and the Bush administration to the SEC's this move. A couple of years earlier, the US Treasury had refused to go along with the suggestions of the EU to introduce stricter international regulations with regard to hedge fund business.[20]

As the governments of the emerging market countries are urged to adhere to the IMF's codes of policy transparency, they are also asked to conform to the new international standards for data dissemination. These standards require national authorities to provide timely, accurate data in a number of areas relevant for global financial markets. The most important in this regard is the IMF's Special Data Dissemination Standard (SDDS). The Fund established the SDDS in 1996 to provide guidelines for countries that have access, or might seek access, to international capital markets. The IMF's move followed the G-7 leaders' call. At the 1995 Halifax summit, which took place in the aftermath of the Mexican peso crisis, the G-7 urged the IMF to develop standards for economic and financial data dissemination; these standards were to be complied by member states in order to ensure the well-functioning of global financial markets (G-7, 1995). The result was the establishment of the SDDS. The SDDS sets specific guidelines with respect to coverage, periodicity and timeliness of economic and financial data, quality and integrity of the disseminated data, and public access to the data. It is useful not only for the Fund's surveillance function but also for surveillance by financial markets. Although

[20] Soon after its establishment, the FSF created a working group on highly leveraged institutions (HLIs). The report by the group recommended strengthening the regulatory oversight of HLI counterparties but not direct regulation of HLIs themselves. The recommendation was endorsed by the FSF (FSF, Apr. 2000; 2002). However, FSF members were not in complete agreement on this issue; the EU wanted more direct regulation of hedge funds, but the US Treasury strongly opposed.

subscription to the SDDS is voluntary, there is strong pressure on countries seeking access to international financial markets to comply with the standard.[21]

Underlying the emphasis on more, better and timely data is the presumption that investors and creditors will use all the available relevant information in making market decisions. This in turn will help reduce market volatility and likelihood of crisis by minimizing surprises. Availability of timely and accurate data is also expected to reduce the risk of contagion when crises do occur, because better informed investors and lenders will be able to differentiate between sound firms and economies, and unhealthy ones. Thus, the premise is the rational efficient market model. But this model is a dismal failure in explaining the actual operation of financial markets, as well as the history of liberal international financial markets, which has been characterized by, as the economic historian Charles Kindleberger (1978) has described, 'manias, panics, and crashes'. Even though availability of reliable economic and financial data might contribute to reducing the spread of a financial crisis, there is no guarantee that investors and creditors will actually take into account available relevant information. As some official international reports on the global financial system acknowledge, international investors have not been factoring into their lending or investment decisions all the important available information that might affect their risk assessments (G-22, 1998a: 36; G-7 Finance Ministers, 1999: Section C, 22). Furthermore, information, quantifiable as well as non-quantifiable, does not interpret itself. It has to be interpreted; interpretation is inevitably a subjective process.

The more important issue is, however, the idea of rational market that underpins much of the global financial reform agenda. One of the strongest critiques of this idea was provided by a liberal economist writing in the 1930s, namely John Maynard Keynes. The key point of Keynes's critique is that financial markets focus on the immediate term rather than the long term. As a result, actual market outcomes, which are determined by the decisions of professional investors and speculators searching for quick large profits, do not coincide with that which is 'socially advantageous' (1997 [1936]: 157). Keynes used the metaphor of a beauty contest to explain the operation of financial markets. He was referring to a tabloid contest in which in order to win each contestant has to try to guess who all other contestants think is most beautiful, not who one actually believes is the most beautiful. In other words, the successful contestant has to anticipate not even what average opinion genuinely thinks, but 'what average opinion expects the average opinion to be' (p. 156). Thus, the game of investment in liberalized, highly liquid global financial markets of our time is like the beauty contest described by Keynes. To win, financial investors engage in a constant game of anticipating what other investors will believe everyone believes. The key to success is the ability to outwit or beat the crowd. As a result, as Eatwell and Taylor (2000: 13) write, there is 'an enormous premium... on any information or signals that might provide a guide to the swings in average opinion and to how average opinion will react to changing events. These signals must be simple and clear-cut. Sophisticated interpretations of the economic data would not provide a

[21] The IMF publishes a list of subscribers on its internet bulletin board, and indicates subscribers that fail to meet the SDDS's specifications as 'not in observance' (http://dsbb.imf.org).

clear lead'. Reversals in what average opinion believes average opinion to be often result in cycles of booms and busts.

INTERNATIONAL STANDARDS FOR CRISIS RESOLUTION

Most of the standards and codes that are in the process of making are aimed at crisis prevention. As we have seen, they focus on prudential regulation, policy transparency and data dissemination. They are premised on the assumption of rational, efficient markets and the desirability of free capital mobility. They either overlook or underestimate the inherent tendency of free capital mobility to generate crises. Those who are in the driving seat of the global financial reform invest a great deal of faith in internationally-coordinated prudential regulation to ensure the stability of liberalized global financial markets. More recently, there have also been international efforts to develop some type of standards and codes for crisis resolution as well, as the international reformers recognize that while strengthened prudential regulation can minimize the risk of crisis, it cannot entirely eliminate it. One of the most controversial issues that have arisen in the course of the reform exercise is that of involving the private sector in crisis resolution and burden sharing, or to use the more popular terminology, to "bail-in" instead of bailing out private creditors.

Three main factors are responsible for the recent move of the international financial policy community to find ways of involving private creditors in the resolution of financial crises. The first reason is to prevent further popular political backlash against the existing liberal global financial system and its institutional architecture. The international official handling of the recent emerging market crises generated a broad based political backlash especially in the crisis stricken countries. The IMF-led rescue operations came under a lot of criticism. Critics argued that the international official financing was used mainly to bail out major banks and institutional bond holders from the major developed countries, although their actions contributed to the occurrence of the crises in the first place. They pointed out that the IMF conditions attached to the loans imposed heavy economic and social burdens on the low income groups and the most vulnerable. It was in fact the case that a major portion of the US Treasury/IMF loan package for Mexico in February 1995 was used to pay off in full the Wall Street holders of Tesobonos (Mexican government bond indexed to the peso/US dollar exchange rate). One of the conditions attached to the loans was Tesobono convertibility. This amounted to denying the Mexican government the option of redeeming the bonds in pesos, and instituting capital controls to stop the dollar flight (Eatwell and Taylor, 2000: 154). In the case of the IMF-led Asian rescue packages in 1997-98, dispersed funds allowed international banks to be largely bailed out, although international bond holders and, to a greater extent, equity investors, incurred significant losses due to the plugging stock market prices. Thus, one purpose of involving the private sector in crisis resolution is to ensure that international private creditors and investors take their share of the cost in a crisis situation. It is hoped that a fairer burden sharing will prevent political backlash against the neoliberal system of free cross-border financial flows.

The second reason is to minimize moral hazard and to promote the effectiveness of market discipline over private financial intermediaries. The IFI's provision of large emergency financing in the recent crises also was attacked from the perspective of moral hazard, an argument which is especially favoured by free-market economists and laissez faire ideologues. The criticism is that such large official loan packages encouraged private investors to engage in reckless lending and risky investments in the EMCs and thus contributed to further crises. It is important to note that while most international private bankers and institutional fund managers share many of the views of laissez faire economists, especially the view of eliminating all barriers to the global mobility of capital, they have strong support for prompt emergency lending by the IFIs to countries in financial distress (Armijo, 2001: 383; Orr, 2002: 205). For example, the influential Washington-based Institute of International Finance, an international association of the world's largest private financial institutions, advocates the view that a substantial amount of lending by the IMF may be required to catalyze private lending when there is a loss of market confidence; but official lending should not serve as a substitute for private lending (IIF, 2001).

Some neoliberal critics of the IMF, especially of its lender of last resort function, put the emphasis on the argument that availability of IMF funds to countries in economic difficulty weakens market discipline and allow governments to pursue unsound and unsustainable policies (see, e.g., Friedman, 1998). Given the fact that the IMF's emergency loans are conditional on strict and increasingly wider range of structural adjustment measures, the argument that they create an incentive for governments of less developed countries to continue with arguably unsound policies hardly has any validity. There is also strong opposition in the US Congress to large financial rescue packages by the US Treasury or the IMF for other countries. Although conservative Republicans in Congress have been among the leading opponents of the Bretton Woods institutions partly because they view the IMF and the World Bank as interventionist, they, together with some Democrats, also criticized the recent US and IMF emergency loans for wasting American tax payers' money. Such views are also influential in the Bush administration. Thus, it is expected that involving the private sector in crisis resolution will lessen the need for large official financing.

Besides these three main factors, another reason for the recent international efforts to create a mechanism for crisis resolution is to ensure a more timely and orderly resolution of financial crises. In contrast to the predominance of bank lending and official loans in international financial flows in the earlier decades, there has been a rapid growth in cross-border trading in securities since the early 1990s. The increased securitization of international financial flows creates new difficulties in the event of debt restructuring. It can be argued that by establishing an international procedure for crisis resolution, the international financial policy communities also seek to prevent unilateral declaration of default or moratorium on foreign debt by a state facing a debt crisis, although such unilateral default or moratorium on sovereign debt is a very rare occurrence.[22]

The Voluntary Cooperation Approach to Private-Sector Involvement

[22] The two major recent cases of sovereign default on foreign debt are Russia in 1998 and Argentina in 2001. Subsequently, the two states negotiated a debt restructuring plan with the creditors.

The informal governmental forums on global financial governance and the IFIs placed the issue of private-sector involvement in the resolution of debt-related crises on their agenda at the end of the 1990s. The G-7 finance ministers first started debating this issue in their report to the G-7 leaders for the Birmingham summit in 1998 in the wake of the Asian crisis (G-7 Finance Ministers, May 1998). The ministers' consensus report framed the issue in terms of the moral hazard problem rather than the principle of social justice. In their report for the 1999 Cologne summit, the G-7 finance ministers offered a framework of basic principles for private-sector involvement. This framework of principles set the tone for subsequent international official discussions on the subject.[23] Soon after it came into existence, the G-20 also placed the issue on its agenda.[24] At its second meeting in Montreal in 2000, the group discussed the issue; but it did not propose any specific measures or solutions that differed from those put forward by the G-7 (G-20, 2000).

The currently dominant approach to private-sector involvement in crisis resolution relies very heavily on voluntary cooperation by international private creditors. It puts the emphasis on market-based and voluntary measures. This approach has the backing of the US government. It is also preferred by multinational banks and institutional investors, who are strongly opposed to any form of forced participation in crisis resolution, such as an international legal framework for sovereign debt restructuring and internationally sanctioned standstills or suspensions on foreign currency debt payments. For example, the influential Institute of International Finance organized a campaign in favour of a market-based, voluntary incentives approach and against involuntary or mandatory measures (see IIF, 2001; 2002a; 2002b).

The specific market-based, voluntary measures that the international policy communities have proposed include the use of collective action clauses (CACs)[25] in sovereign or quasi-sovereign debt contracts, especially bond issues, in order to facilitate orderly debt workouts or debt restructuring in the event of unsustainable debt or a debt crisis; use of roll-over options in debt instruments; and more reliance on market-based contingent credit lines. It is sovereign and private institutional borrowers in EMCs who are asked to use CACs in their international debt contracts. The reason why the international financial reform agenda puts an emphasis on promoting the EMCs' use of CACs is the increasing securitization of EMCs' external debt in contrast to the earlier predominance of syndicated bank loans. EMC governments were initially rather reluctant to use such clauses in their international bond issues. This was because the inclusion of such clauses in their bonds might create the perception that they are high risk borrowers or contemplating a debt restructuring in the future. This would increase the cost of borrowing for them as investors would demand extra risk premiums. In the last two to

[23] The Interim Committee of the IMF also endorsed the G-7's framework of principles (IMF, Sep. 1999b).
[24] The G-22, the predecessor of the G-20, took up the same issue in 1998. The report produced by its working group on international financial crises proposed some specific solutions with the emphasis on ex-ante voluntary contractual arrangements between sovereign borrowers and international private creditors (G-22, 1998b).
[25] Collective action clauses include majority decision making by creditors to alter the payment terms of a debt contract; sharing of payments by the debtor among creditors; collective representation of creditors; and minimum legal thresholds for creditor lawsuits.

three years, an increasing number of EMCs have started, though reluctantly, to include CACs in the international issues of their sovereign bonds partly due to increased pressure from the G7 and the international financial institutions.

A more recent initiative is the proposal of a voluntary code of good conduct in sovereign debt resolution. The agency responsible for formulating such a code is the G-10, which represents the biggest creditor countries. The G-20, which includes major borrowing countries, is also involved in the process, but the main responsibility for preparing the code lies with the G-10. The purpose of the proposed conduct is to provide guidelines for sovereign debtors and their creditors in order to facilitate a more orderly and timely resolution of a financial debt crisis. It is also to prevent a debtor government from unilaterally defaulting or declaring moratorium on its international debt. This move to establish a voluntary code for sovereign debt resolution took place as a result of the failure of the IMF's proposal for a Sovereign Debt Restructuring Mechanism (SDRM) to receive enough support.

The IMF proposal for a SDRM was first made public by the first deputy managing director Anne Krueger in November 2001. It was based on a statutory approach to the resolution of sovereign debt crises and private creditors' role in crisis resolution.[26] The proposal generated intense debate. Institutional investors made it known that they would fight the proposal. The US Treasury declined to support the IMF proposal. Consequently, Krueger revised the proposal in order to bring it more in line with private international creditors' and the Bush administration's preferences for a market-based, voluntary approach to sovereign debt restructuring (Sharma, 2004). The revised proposal included a second approach which was based on the use of CACs.[27] Its underlying principle and purpose were the same as the use of CACs in debt contracts. It was based on the view that the main impediment to timely and less costly debt restructuring is the collective action problem especially when debt is held by numerous and diverse creditors, as is increasingly the situation because of the shift from syndicated bank loans towards traded securities in the EMCs' sovereign debt.[28] However, unlike the contractual use of CACs, the SDRM would be based on a binding international treaty. The treaty framework would include measures similar to CACs. But unlike contractual CACs which bind only the holders of the same issue of the debt instrument, the CACs of the treaty/statute established by the SDRM would bind all holders of a sovereign debtor's foreign currency debt.

One striking measure included in the SDRM proposal was temporary foreign exchange, or capital controls, to prevent capital flight. The IMF report on the proposal mentions two

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[26] The idea of applying bankruptcy procedures to sovereign debt is not new. It has been discussed in the academia for quite some time. For a review of different proposals since the late 1970s, see Rogoff and Zettelmeyer (2002). Eichengreen (1999: 90-3) also provides a brief review.

[27] The report entitled 'A New Approach to Sovereign Debt Restructuring' was prepared by Anne O. Krueger, the first deputy managing director. It was released in April 2002. All my references concerning the SDRM proposal are to this report.

[28] Collective action problem refers to the situation when a small number of creditors can block the renegotiation of the terms of a debt contract, or a restructuring agreement approved by a majority. Another major difficulty is the coordination of numerous creditors.

circumstances that might require use of exchange controls by national authorities: capital flight triggered by sovereign debt default; and financial crisis arising from the overindebtedness of the private-sector banking and corporate sector and a loss of creditor confidence leading to the depletion of the country's foreign exchange reserves. Although the report did not go as far as directly incorporating exchange controls into the SDRM, even the recognition that comprehensive exchange controls might be needed in the event of a serious financial crisis is rather important in view of the IMF's promotion of capital market liberalization over the last couple of decades. This does not, of course, mean a reversal of the IMF's policy of active support for open global financial markets, or capital account liberalization. But in the wake of major financial crises in a number of emerging markets, a more cautious approach to capital account liberalization in less developed countries has emerged in the IMF as well as other relevant international decision-making bodies.

Even this market-friendly proposal by the IMF, which covered only sovereign debt and excluded private-sector debt, encountered strong opposition, including from the biggest shareholder of the Fund, that is, the US government. As a result, soon after it was presented for discussion, it had to be shelved. The American government has strong objections to an international statutory mechanism for sovereign debt restructuring. Reflecting the concerns of private international investors and creditors, it has been pushing for a more voluntary way of securing private creditors' cooperation in resolving debt crises. Furthermore, despite the fact that the US government exercises a great deal of influence in and through the IMF, it is not likely to agree to empower the Fund, or any other international organization, to enforce a stay or standstill on international private creditors.[29] Without the backing of the US, which has the largest credit and loan market in the world, such a mechanism cannot be successful.

Powerful global financial conglomerates and international financial investors also led an active campaign against the IMF's SDRM proposal.[30] They warned that such a mechanism would amount to excessive interference with private contracts and weaken investors' rights. They warned that it would undermine international credit markets by making sovereign default too easy. (Kenen, 2001: 138-9; Sharma, 2004; 638). Private international creditors were particularly concerned that the SDRM could strengthen the hands of sovereign debtors in negotiations over debt restructuring and reduction, and as a result, hey might be forced to take cuts on their claims (Sharma, 2004: 638).

It should be pointed out that there was no enthusiastic support from the EMCs for the IMF's SDRM proposal. Governments of some EMCs raised concerns that the SDRM

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[29] The US still has enough votes in the IMF to veto an amendment to the Articles of Agreement.

[30] The Institute of International Finance, e.g., expressed strong opposition to the IMF's SDRM, and produced an alternative proposal. This proposal is based on a market-based approach to crisis prevention and resolution, and includes the following measures: broadening the use of CACs and market-based voluntary incentives; creation of a private sector consultative group for continuous consultation between indebted states and their international private creditors; and 'a targeted legal strategy' to deal with 'vulture' funds (IIF, 2002a; 2002b). According to Alan Beattie's report in *Financial Times* (8 October 2002), large institutional investors also lobbied the IMF and its biggest shareholder governments to take the SDRM off the table.

might make it more difficult and more expensive for them to raise funds on international financial markets. They were also unhappy about the possibility of increased powers for the IMF if the SDRM came into existence.

G-7 governments other than the US expressed varying degrees of support for an international statutory mechanism for the resolution of debt crises, like the one proposed by the senior staff of the IMF. For example, in 2002, the Department of Finance of Canada endorsed the idea of an international bankruptcy mechanism.[31] In defending the idea, the former Canadian Minister of Finance Paul Martin, who was its strong supporter, stated: ‘Clearly, we have to resolve crises in a manner that will not cause private capital flows to dry up. But equally, we have to make sure that countries are not forced to undertake draconian adjustment policies that lead to severe social disruption...’ (Martin, 2002: A15). The Canadian proposed international bankruptcy mechanism would act as an arbitrator with authority to declare mandatory standstill on debt payments by a country facing a debt crisis (Martin, 2002; *The Globe and Mail*, 1 May 2002: B3; 2 May 2002: B5.) The idea of an international bankruptcy system is based on the same principle as domestic bankruptcy courts in capitalist economies; but the deeply embedded principle of state sovereignty makes it impossible to create a fully fledged international bankruptcy court that will have powers over sovereign states similar to the powers domestic bankruptcy courts generally have over corporate debtors. As the IMF had to abandon its essentially market-based proposal for an international debt restructuring procedure, the idea of creating an international legal mechanism to involve the private sector in the resolution of financial debt crises and to ensure that it shares a fair share of the burden is no longer on the official reform agenda.

There is a fundamental problem with the voluntary cooperation approach to private-sector involvement, which is currently the dominant approach. It puts the onus on the crisis-stricken, debtor country to secure private creditors’ cooperation. A recurring feature of financial crises is creditors’ panic and herd-like behaviour, as seen during many of the recent emerging-market crises. Herd behaviour often leads to massive flows of capital into favoured countries or sectors. At a certain point, a panic sets in among financial investors, which can be triggered by an event and some news, even rumours. Excessive financial inflows may be followed by sudden, massive outflows of capital, which are not justified by the economic fundamentals of the countries concerned. In the absence of national capital controls or a fair international mechanism for resolving financial crises, creditors rush to pull their money out of the country, each hoping to recover its money before others get theirs. The result is local economies left devastated by fleeing international financial investors. What appears to be subjectively a rational behaviour for individual investors thus turns out to be objectively irrational and destructive for the economy as a whole. In such a situation, the crisis-stricken country is often forced to adopt very harsh polices in order to regain the confidence of international investors. As the debtor country finds itself unable to service its debt and thereby does not have much choice but to restructure the debt, creditors usually demand generous

[31] Four years earlier, the Canadian Department of Finance had released a “six-point Canadian plan”. This plan suggested an ‘emergency standstill clause’ (ESC), which was to be legislated by IMF members into domestic law (see Department of Finance of Canada, Sep. 1998).

settlements before they agree to a restructuring plan. In some cases, foreign creditors also demand that the government of the country should guarantee or even take over the debt owed to them by local private banks and firms. One might argue that a sovereign debtor can default or unilaterally declare a moratorium on its debt. Although such an action is possible, it is not very plausible because a state defaulting or declaring moratorium on its foreign debt will find it very difficult to regain access to international financial markets and restore investor confidence. As the defaulting country is denied new credits, and thereby unable to pay for essential imports, its economy will further suffer (Khor, 2000: 156). It is thus no surprise that there have not been many cases of unilateral default or moratorium by states. There is an urgent need for an international institutional mechanism for the resolution of debt related crises. The purpose of such a mechanism should be not only to assist in a more timely and orderly resolution of crises, which is emphasized by the dominant voluntary approach, but also to provide a fair system of burden sharing. The market-based, voluntary type of measures is not likely to ensure that private creditors take their share of the costs. For such an international mechanism to achieve its objective, it will need to be fortified by capital or currency controls at least for a certain period of time until the crisis is resolved.

Conclusion

The international standards and codes that are being constructed for regulating the liberalized financial markets are premised on the assumption of great benefits of open capital markets. They are pro-market in nature, and most are prudential type of regulations the purpose of which is to maintain the stability of the global financial system by ensuring the basic safety and soundness of financial institutions. The core principle underlying these regulations is the freedom of mobility for capital. The primary aim of international financial standards and codes is to encourage the EMCs to put in place appropriate prudential and supervisory institutions as they remove restrictions on cross-border financial flows and further integrate into the global capital market through capital account liberalization. Thus, under the reform of the global financial architecture, the EMCs must observe the principle of liberalized international financial flows; at the same time, they must bear the substantial costs of implementing wide-ranging reforms to their prudential systems and financial sectors in order to make them safer for the entire global financial system. However, there is no systematic evidence showing that the EMCs have enjoyed significant benefits from capital account liberalization (Little and Olivei, 1999: 73-5). Indeed, many of them suffered one or more financial crises following capital account liberalization. The strengthening and minimum international harmonization of prudential regulations is not likely to be very effective in preventing crises in liberalized and globally integrated financial markets. By rejecting capital controls, especially controls on capital outflows,[32] the existing global financial architecture leaves the EMCs at the whims of international institutional investors and professional speculators.

[32] The international financial policy communities recently came to look at market or price based controls on financial inflows (a la Chile) more favourably in order to discourage excessive short-term inflows for a temporary period. But they continue to oppose controls on capital outflows even in the event of a financial crisis.

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