BETWEEN THE STORMS:

PATTERNS IN GLOBAL FINANCIAL GOVERNANCE, 2001-2007

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Global financial governance is marked by a paradox: while financial markets are among the fastest-evolving economic activities, their governance is most of the time reactive rather than forward-looking. As the previous chapter has confirmed (Germain, ch. 1 in this volume) , dramatic changes in the patterns of global financial governance are most of the time triggered by major financial crises, which politicize the regulatory debate, and pressure policymakers to react. But when the storm has passed both public authorities and private actors tend to be affected by what Reinhart and Rogoff (2008) have called the "this time is different syndrome". Confidence is restored and a certain degree of complacency sets in, until a new storm breaks out, opening a new cycle in the governance of financial markets.

Recent experience has been no exception to this rule. Between 1994 and 2001, the world financial system was shaken by a series of major crises emanating from "emerging markets" (EM), most notably in Mexico in 1994, East Asia in 1997-98 and Argentina in 2001. These crises prompted the leading financial powers of the G7 to launch a set of ambitious regulatory and institutional reforms to create a "new international financial architecture" (NIFA). This reform agenda has been well documented elsewhere (e.g. Eichengreen 1999, Kenen 2001) but its results after 2001 have received less attention. After briefly outlining the NIFA project, we highlight in this chapter how the absence of serious crises between 2001-07 weakened the urgency of this reform agenda for G7 governments and scaled back the level of its ambitions, giving way to greater reliance on market-based governance mechanisms.

But we argue that the NIFA project was weakened not just because of G7 complacency. Equally important were the reactions of many EM governments who had learned a different set of lessons from the crises than the G7. Many EM governments were much more inclined to blame international financial markets – as well as the G7-dominated IMF - for the crises and they worked to bolster their autonomy from these external pressures.

The result of these trends was a rather incoherent system of global financial governance in the 2001-07 period, with public authorities in different parts of the world working in separate directions. Where, then, is global financial governance headed? In the conclusion, we suggest the new US-centred financial storm that broke out in 2007 likely signals a turning point in global financial governance. Despite its contradictory trends, the 2001-07 period was unified by its common reference to the 1994-2001 crises. There is now a new reference point and the distinct features of the present crisis are likely to prompt different kinds of political responses.

The G7 Push for a New International Financial Architecture

The content of the NIFA project reflected the lessons that many policymakers from G7 countries drew from 1994-2001 crises in emerging markets. The dominant view among G7 policymakers – particularly those from the US - was that the roots of these crises lay in the inadequate domestic institutions and policies of EM governments, rather than in the instabilities of international financial markets.[1] Consistent with this diagnosis,

G7 policymakers urged EM countries to increase the transparency of their domestic financial systems and upgrade their regulatory and supervisory practices closer to Western practices. The instrument to promote this project became the formulation and global dissemination of a common set of international best practice standards and codes (Walter 2008: ch.1). These were defined by the UK Chancellor of the Exchequer Gordon Brown (2001) as the "new rules of the game […] not incidental to the financial architecture for the new global economy: they are the financial architecture for the new global economy".

This "standards and codes" agenda took off in the aftermath of the Mexican crisis in 1994, which was blamed on the Mexican government's excessive borrowing and macroeconomic policies. The lead-up to the crisis was seen to be aggravated by the lack of data about Mexico's financial position, and the IMF responded to a request from the G7 by developing in 1996 the "Special Data Dissemination Standards". This initiative was followed by codes of good practice on transparency for fiscal, monetary, and financial policies in 1998 and 1999. When the new financial crises broke out in 1997 among East Asian countries, many of whose macroeconomic fundamentals appeared sounder, the G7 expanded the agenda to microeconomic factors. East Asian countries had been left exposed to the instabilities of international financial markets because of their "sins of omission", such as lax supervision and prudential regulations of the financial sector, and their "sins of commission", such as the opaque relations between corporations, banks and the government (so called-"crony capitalism") (Haggard 2000; Corsetti et al. 1998). Codes of best practices were thus developed in a broader range of financial areas, such as banking, securities, and insurance supervision, accounting and

auditing standards, corporate governance, and payment systems regulation. The expansion of the agenda created demands for "transparency about transparency". In 1999, the IMF and World Bank began to assess the extent to which countries observe certain internationally recognized standards and codes within their Article IV Consultations, as well as introducing a new "Financial Sector Assessment Program" (FSAP), and compiling "Reports on the Observance of Standards and Codes" (ROSCs).

In order to strengthen the institutional basis of this "standards-surveillance-compliance" regime (Wade 2007), the G7 created the Financial Stability Forum (FSF) at the Cologne Summit in 1999. The FSF tried to rectify the lack of coordination among financial regulators, by bringing together for the first time the treasuries, central banks, and supervisory agencies from the G7 countries (with the later inclusion of Australia, the Netherlands, Singapore, Hong Kong Monetary Authority, and recently Switzerland), as well as representatives from the major international financial institutions. The G7 also sought to strengthen the legitimacy of the NIFA by reaching out to EM officials through the creation of a Group of 20. This was an informal forum that included finance ministers and central bankers from both the G7 as well as other countries in Asia (China, India, Indonesia, South Korea, Russia), Africa (South Africa), the Middle East (Turkey, Saudi Arabia) Latin America (Mexico, Brazil, Argentina), and Australia. The membership of the BIS was also expanded after 1996 from 36 to 55 members, and representative offices were opened in both Hong Kong (1998) for the Asia and Pacific region and Mexico City (2002) for the Americas.

It was not just EM governments that were blamed for the crises of the 1990s. Many G7 countries also criticized their own practice of bailing-out private international

investors by providing ever-larger rescue packages, primarily via the IMF (see chapter 7 by de Jong and van der Veer). When Latin American governments threatened to default on loans to the largest Northern banks in the early 1980s, international bailouts had been more justified because of the clear risk of a meltdown in the international financial system. But as financial flows to emerging markets shifted from bank loans to bond finance, this rationale made less sense since defaults to thousands of individual Northern bondholders posed no systemic risk. After the US Treasury and the IMF had directed $50 billion of official financing to Mexico – the largest package in the history of the Fund – these bailouts started to be described as part of the problem rather than the solution. They appeared to create "moral hazard" at the international level by simply rewarding investors for their poor investment choices at the taxpayer expense.

When the IMF was called upon again during the East Asian crises of 1997-98, the criticisms of bailouts became even more intense and the G7 began to press private-sector creditors to assume more of the burden of adjustment to the EM crises. The "bailing-in" of private investors began during the South Korean crisis of 1998, and several subsequent crisis in Ecuador, Pakistan and Ukraine in 1999-2000, when the IMF pushed investors to accept debt restructuring at the outset of debt crises (Blustein 2001, 2005) The new policy was then implemented much more dramatically during the Argentine crisis. As the country headed for crisis in late 2001, the IMF refused to extend new loans, a move that helped to trigger the country's massive default. The IMF and G7 then made clear that they would do little to protect the interests of private holders of Argentine bonds during the latter's subsequent negotiations with the Argentine government (Helleiner 2005, Taylor 2007).

The G7 also explored new ways of institutionalizing the “bailing-in” of private investors. In 1996, a report from the G10 recommended that collective action clauses (CACs) could be written into international bond contracts. These clauses provided a framework for restructuring negotiations between bondholders and debts by allowing such things as qualified majority voting by bondholders to alter terms and conditions of bond contracts, and restrictions on the ability of individual creditors to sue debtors or demand full repayment. When this recommendation was largely ignored by investors, attention soon focused on the creation of a more formal international bankruptcy mechanism. In a high profile speech in November 2001 (one month before the Argentine default), the IMF’s deputy managing director, Anne Krueger backed this idea, proposing a new IMF-led “sovereign debt restructuring mechanism” (SDRM) (Helleiner 2009).

G7 Complacency and the Push for Market-Based Forms of Governance

The Argentine crisis in 2001 represented a turning point in the G7 attitude towards the reform of the international financial architecture. Although the 2001-2007 period continued to be plagued by asset bubbles in several markets and growing global imbalances, there were no more major financial crises generated in EMs during this period of the kind that had triggered the reaction by the G7 since the mid-1990s. Unlike the East Asian crisis, whose effects had spread to Brazil, Russia, and ultimately to the US with the quasi-collapse of the hedge fund Long Term Capital Management, the Argentine default was also followed by a marked decline in international contagion. The decoupling of spreads between Argentine bonds and neighbouring countries’ debt was presented as

evidence of the success of the initiatives undertaken in the previous years. The Undersecretary of the US Treasury John Taylor (2007) argued that the greater transparency had enabled investors to anticipate the events in Argentina, and prevented the disorderly winding down of positions from other emerging countries that had followed the default by the Russian government in 1998. At the same time, the absence of a bailout of foreign investors during the Argentina crisis was seen to have sent an important signal to the markets, limiting the moral hazard for the future.

These considerations, and the absence of further major financial crises in emerging markets lowered the relevance of these countries and the NIFA on the G7's priority list, and generated a certain degree of complacency. While references to the need to "strengthen financial stability" and implement standards and codes were a quasi-mantra in the G7 statements at the end of the 1990s, they ceded their place after 2001 to other issues, such as fight against money laundering and terrorist financing, the HIPC initiative, fluctuations in the oil prices, and exchange rates. The 9/11 terrorist attacks led the new US administration to prioritize security issues over global economic reforms (e.g. the 9 Special Recommendations on Terrorist Financing released in 2002 by the Financial Action Task Force, see Tsingou, ch. 9 in this volume), while major regulatory initiatives within G7 countries emerged more at the national level in reaction to domestic scandals (e.g. Sarbanes-Oxley Act in the aftermath of the Enron and Worldcom scandals).

The restored confidence in the stability of the markets encouraged G7 officials to give greater emphasis to market-based forms of governance, and to the delegation of regulatory functions to the private sector. The trend was apparent, for example, in the debate that followed Krueger's 2001 proposal to create a SDRM. Many G7 policymakers,

particularly those in the Bush administration, soon argued that this “statutory” approach was too ambitious and overly bureaucratic, and their opposition – along with that of leading EM governments (see below) - forced the IMF to drop the proposal by 2003. Instead, G7 policymakers threw their weight behind the more market-oriented CAC approach to debt restructuring, and they worked hard and successfully to encourage market actors to embrace CACs as a market norm. At the end of 2002, only 30% of sovereign bonds issued by emerging markets had CACs. By the first half of 2005, the figure was close to 100% (Helleiner 2009).

The G7 also supported the creation of the voluntary code of conduct to govern future debt restructuring processes that had been promoted as an alternative to the SDRM by the leading lobby group of private international banks, the Institute of International Finance (IIF). The code was designed to influence the behaviour of both investors and debtor governments with respect to information sharing and transparency, debtor-creditor dialogue and cooperation, good faith actions in debt restructurings, and equal treatment of all investors in case of defaults. In late 2004, the IIF succeeded in securing the code’s endorsement by four key EM governments (Brazil, Mexico, Turkey and South Korea) as well as by one other financial industry association, the International Primary Market Association (which represented debt underwriters). The US and many other G7 governments openly welcomed this initiative – as did the G20 as a whole - and the code was soon backed by over thirty other countries. The code’s implementation and further development continues to be promoted by the IIF which has established a secretariat and several advisory bodies, comprised of private sector representations and government officials and ex-officials, for this purpose (Helleiner 2009).

The G7 preference for more market-based forms of regulation was apparent in other areas as well. In the field of international bank regulation, the new "Basel II" Agreement, published in 2004, still required internationally active banks to hold capital equal to at least 8 percent of risk-weighted assets, but it allowed the most sophisticated financial institutions to use their own internal models and data bases to self-assess their risk exposure. Commercial credit rating agencies (e.g. Moody's, Standard and Poor's) were also given a semi-regulatory role, as the less sophisticated banks could now weight the risk of their sovereign and corporate exposures according to their ratings (Claessens and Underhill, ch. 6 in this volume).

The Financial Stability Forum also endorsed international accounting and auditing standards that were set out by two private international standard-setting bodies, the International Accounting Standards Board and the International Auditing and Assurance Standards Board. The influence of the IASB was bolstered further by the European Union's decision to require that all companies listed on an European stock exchange since 2005 publish their consolidated financial statements according to its reporting standards. There are now more than one hundread countries worldwide that allow or require listed companies to adopt these accounting standards (Kerwer 2008). In addition, industry-driven initiatives have increasingly covered not just the more technical aspects of financial governance (e.g. Counterparty Risk Management Policy Group in 1999 and 2005) but also the societal "externalities" of firms' activities, such as environmental standards (the Equator Principles since 2003, see Wright and Rwabizambuga 2006) and anti-money laundering standards (Wolfsberg Principles since 2000, see Pieth and Aiolfi 2003).

Some analysts have interpreted the growing significance of these private governance mechanisms and their capacity to replace or prevent the emergence of public regulation as evidence of a dramatic shift in power in the global financial realm away from states. However, these arguments underestimate the role played by public authorities in encouraging this trend. G7 governments in some cases actively triggered the emergence of market-based governance mechanisms by delegating regulatory functions or threatening a more stringent public intervention. More frequently, public authorities strengthened and legitimized pre-existing private initiatives by exercising their "power of endorsement" (Baker, ch. 3 in this volume). Therefore, even when they were not directly created by public authorities, it is more accurate to see market-based governance mechanisms as taking place within the "shadow of the state" (Ronit and Schneider 1999; Scharpf 1997, Pauly 2002).

Why did these leading financial powers deliberately encourage the shift of regulatory authority to the private sector? As discussed in the Introduction to this volume, the close correspondence in this period between the policy outcomes and the preferences of the private sector could be interpreted as an example of "policy capture". In this period, public authorities were permeable to the influence of private actors, and the benefits and legitimacy of this involvement were not openly questioned (Tsingou 2007). However, the "regulatory capture" interpretation needs to appreciate how the legitimacy of market-based governance mechanisms was highly dependent on the historical context, as well as the possibility that this process could be reversed in the future. In a period of renewed financial stability and diminished demand for heavy-handed public regulation, public authorities found market-based governance mechanisms attractive as a tool to help

them “walk a fine line between stability and competitiveness” - as Singer (2007:23) describes the regulators’ dilemma. Especially in the US, public authorities have regarded the involvement of private actors as a viable solution to govern the markets without imposing traditional “command-and-control” forms of regulation, often depicted as too burdensome for the competitiveness of their domestic financial industry and the benefits it brings to the economy (see Paulson 2008).

Underlying the proximity between the interests of public authorities and those of the private actors in favour of market-based governance mechanisms, there was a benign view of global financial markets, which were seen as capable of governing themselves, and ultimately acting in the public interest once the kind of government intervention that had contributed to the crises of 1994-2001 was corrected. This faith was particularly strong among Bush administration officials who came to power in 2001. Many of them had been severely critical of IMF bailouts on moral hazard grounds, with some, such as Taylor, even going so far as to advocate the abolition of the IMF before they had assumed office (Helleiner 2005). In their view, markets were best at understanding and pricing risk, while government intervention was usually inefficient and distorting. Indeed, in retrospect it appears that the period of relative financial stability between 2001 and 2007 created the conditions for the increased reliance on market-based governance mechanisms rather than the other way around, as Taylor had argued. As will be discussed more in detail in the conclusion, when the period of financial stability ended in 2007, the shadow of the state quickly loomed much larger on market-based governance mechanisms, creating doubts about their sustainability.

Reactions Among Many EM Governments

It was not just the increasing complacency and changing priorities of G7 governments that undermined the impetus behind the NIFA initiative. Also important were the reactions that the NIFA agenda generated among many EM governments (see the introduction to the volume). In many EM countries, the crises of the 1994-2001 had taught different lessons than those drawn by G7 governments (see Armijo 2001). EM governments were inclined to see the roots of the crises in fickleness and irrationality of international financial markets more than in crony capitalism practices or inadequate domestic financial regulations. From this perspective, the crises demonstrated very plainly the severe economic costs that could result from overdependence on such markets.

The crises also highlighted their vulnerability to Western and IMF influence. During the East Asian crisis, the IMF had imposed very extensive conditionality which went well beyond the standard programs and generated widespread opposition. In the best-case, the IMF's advice was deemed inappropriate and blamed for worsening the crisis in many countries. In the worst-case, many saw behind its intervention a "Wall Street-IMF-Treasury Complex" trying to use the crisis to promote its strategic and economic goals in the region (Wade and Veneroso 1998). The IMF's reputation was undermined further by the Argentine economic collapse of late 2001 (see ch.10 by Victor Klagsbrunn). Argentina had been under the ten year watchful eye of the IMF and was widely seen as one of the IMF's "star pupils" in the region throughout the 1990s.

Many EM governments thus saw themselves much more as victims of external forces than as actors to be blamed for crises. From this vantage point, many of them drew the conclusion that they needed to protect their national autonomy more carefully from overdependence on international financial markets and external influence. This perspective left them skeptical of key parts of the G7 agenda for a new international financial architecture.

Many EM governments were particularly wary of the G7-led initiative to develop standards and codes as benchmarks to evaluate the soundness of their financial systems. What were presented by the G7 as international best practices derived from the experience of industrial countries, and in particular the predominance of American and British regulators. The G24 – the main intergovernmental group of developing countries in international financial affairs - expressed concern about the implementation costs for countries with limited human and financial resources, as well as the appropriateness of a "one-size-fits-all" approach in countries at varying stages of development and coming from different traditions. More deeply, resentment arose from the asymmetry between the obligations on public institutions in EM countries and the private sector in Northern markets (Mohammed 2003). The asymmetry in the agenda is not surprising since EM countries had been offered little say in the development of their content. With the exception of IOSCO, all the standard setting bodes were deficient in the representation of emerging countries. The only authorities from EM countries represented in the newly created FSF were Singapore and the Hong Kong Monetary Authority, while EM governments have much less voice than the G7 in the IMF, and are not represented at all

as full-members in the decision-making committee of the Basel Committee (see Delonis 2004).

Reaction to the G7 standards and codes project took varying forms (Thirkell-White 2007). Through the G24, EM governments successfully resisted the G7 attempts to include adherence with standards and codes among the conditionalities attached to regular IMF loans. Countries did accept voluntary monitoring by the IMF and World Bank through their ROSCs and the FSAP, but they reserved the right to block the publication the results. Faced with this resistance, the G7 hoped that the ROSCs would at least encourage financial markets to discipline non-compliant countries, but the markets generally failed to perform this role. Moreover, Andrew Walter (chapter 5 in this volume) has highlighted how many countries have engaged in "mock compliance" of various standards and codes, particularly those which were hardest to monitor and more costly for the private sector, such as accounting and corporate governance.

Some EM governments also played a role in defeating the SDRM proposal in the 2001-03 period. Part of their opposition stemmed from a fear that an international bankruptcy court might increase the costs of international borrowing for EM countries. Mexico and Brazil, in particular, highlighted this concern. But they were also wary of granting new powers to the G7-dominated IMF to interfere in their policymaking autonomy. To make debt restructuring more orderly, they preferred to minimize external constraints on their behavior by backing more limited initiatives of introducing CACs and the voluntary code of conduct (Helleiner 2009).

In addition to resisting G7 initiatives, many EM governments took more proactive steps to boost their policy autonomy. Malaysia's temporary introduction of capital

controls at the height of the East Asian crisis is of course one famous example. But more enduring initiatives have included the accumulation of foreign exchange reserves as a shield against future international financial instability. By 2007, the sums involved have become massive, particularly in the East Asian region. Large-scale reserve accumulation enabled EM countries not just to protect themselves against speculative market attacks (and thus check out of the Hotel Capital Mobility, in Underhill's words) but also to reduce their dependence on the IMF. Many countries – including some of the IMF's largest borrowers such as Brazil, Argentina, and Indonesia – have paid off their IMF loans early and suggested that they have no intention of borrowing from the Fund again. These moves have been portrayed locally as a kind of boycott of, or declaration of independence from, the G7-dominated financial institution (Helleiner and Momani 2008).

While boosting national autonomy, the "self-insurance" of reserve accumulation has been costly when the reserves are held conservatively in low-earning assets such as US Treasury bills. As a result, some countries with large reserves have begun investing them more aggressively in global markets through the creation of "sovereign wealth funds". This trend has worried the US and some other OECD governments who fear that the growing influence of these funds may increasingly "politicize" global financial markets. In this way, the EM governments' quest for policy autonomy has increasingly had systemic consequences.

This is not the only way in which many EM governments have begun to transform the international financial order in more pro-active ways. In East Asia, the 1997-98 crisis encouraged region-wide initiatives to create alternative financial arrangements that might provide an additional layer of protection against external influences. To this end, the

ASEAN countries, along with Japan, China and South Korea, launched the Chiang Mai Initiative in 2000 creating a set of bilateral swap arrangements among the region's monetary authorities. As initially implemented this initiative posed little challenge to the IMF's role in the region since governments requesting more than 10% of the funds had to have IMF programs in place. But the threshold was raised to 20% in 2005 and further changes of this kind appear likely, thereby diminishing the IMF's role in the region (see Dieter, ch. 14 in this volume). In 2008, they also agreed to "multilateralize" the Chiang Mai Initiative by creating a self-managed multilateral reserve pool governed by a single agreement. The "multilateralization" of the CMI and the increase of its expansion to at least $80 billion, are thus moving financial cooperation in East Asia closer to the $100 billion "Asian Monetary Fund" (AMF) that had been proposed controversially by Japan – and opposed by the US – in 1997, at the height of the East Asian crisis (ASEAN+3 2008).

Dissatisfaction with the IMF in Latin America has also generated interest in regional financial arrangements. One such arrangement has been the creation of the Banco del Sur in 2007 with seven members (Argentina, Bolivia, Brazil, Ecuador, Paraguay and Uruguay). Not surprisingly, the Banco was promoted most actively by those most critical of the Fund, including Venezuelan President Hugo Chavez and Ecuador's Rafael Correa as well as Argentine President Nestor Kirchner whose tough and successful bargaining with the IMF in 2003-05 had done much to undermine the IMF's powerful image in the region. In the early stages of planning, these advocates had hoped the Banco could provide both long-term development loans and short-term balance of payments financing in ways that allowed Latin American countries to reduce their

dependence on both the World Bank and IMF. But these ambitious were watered down considerably, particularly by Brazil, and the final agreement commits the Bank to use if $7 billion initial capital only for long-term development lending. Although not thus a challenge to the Fund, the creation of this institution marks another way in which many developing countries are moving from the position of "rule-takers" into "rule-makers" in the international financial realm (Sohn 2005).

From the Calm to a New Storm

In sum, the post-2001 period saw the emergence of two trends in global financial governance. In G7 policymaking circles, the lack of major financial crises since 2001 generated a certain degree of complacency and encouraged a greater reliance on market-driven governance mechanisms. In many EM countries, the distinct lessons drawn from the crises of 1994-2001 led governments to bolster their country's autonomy from external pressures, pursuing different initiatives often in contrast with those promoted by the G7.

Although these two trends were often contradictory, they both contributed to weaken the NIFA project, particularly the development and implementation of the "standards and codes" agenda. The design of new international standards and codes has clearly lost the momentum it had right after the East Asian crisis. And the implementation of existing standards and codes remains uneven, with compliance problems affecting not only emerging countries, but also the G7 countries that were the

main promoters of the NIFA. Although the US has supported mandatory participation in the review process (Walter 2008), it has released only two ROSCs and it has agreed to publish its first FSAP only in 2009[2]. Germany also failed to publish any ROSC until 2003 (Schneider 2003). In the case of EM countries, incentives to comply with the existing standards and codes have continued to been weakened by the lack of representation in the standard-setting process. They have been included in standard-setting bodies only on *ad hoc* basis into consultative committees (e.g. Core Principles Liaison Group created by the Basel Committee, or the regional meetings struck by the FSF), without gaining a seat at the decision-making table. Here we have a prime example of the volume editors' argument that the lack of inclusiveness undermines the effectiveness of governance initiatives.

In addition to undermining the NIFA project, the two post-2001 trends have also worked to marginalize the IMF. From the perspective of many policymakers from the US and other G7 countries, the IMF was an overly bureaucratic institution, too committed to bailout lending. At the same time, many EM governments have seen its conditionality as overbearing and its operations too dominated by G7 governments and free market ideology. To address both these criticisms, the IMF has undertaken a number of reforms, including most recently to its governance structure to increase the voting power of under-represented emerging and developing countries. But the results have been limited, and certainly not enough cultivate much new enthusiasm for the institution. At the same time, and compounding its difficulties, the IMF has been suffering an internal financial crisis because its lending – and thus the interest it earns on its loans – has rapidly shrunk with

the build up of reserves in many EM countries, the early repayment of debts by its main borrowers, and the absence of major crises (Helleiner and Momani 2008; Torres 2007).

With the benefit of hindsight, then, the era of 2001-07 will be remembered not just for its relative financial stability. It was also characterised by a rather incoherent system of global financial governance, with public authorities in different parts of the world working in separate directions, the new international financial architecture never fully emerging, and the IMF suffering one of its most difficult moments. Each of these trends might well have endured were it not for the sudden appearance of a new international financial crisis in 2007-08 which, in our view, marks a turning point in the evolution of global financial governance.

The crisis has shaken off the complacency of the 2001-07 period and the confidence in the strength of the existing governance arrangements. The attention of public authorities has been re-focused on issues of financial stability, with some even calling once more for a "new international financial architecture' (ironically, including once again the now-British Prime Minister Gordon Brown). But would-be financial architects are likely to have quite different objectives this time around. The NIFA had placed emphasis on the need to address government-failures in emerging countries, assuming this would be the most likely cause of a future crisis. The subprime mortgage crisis encourages a radically different focus in two ways. First, the consensus among G7 policymakers is that market actors and not simply government policies are key culprits in this instance. Second, the epicenter is not in a developing country but at the very core of the global financial system: the American financial markets. It is, of course, impossible to

predict how these two differences will steer the patterns of financial governance in the future, but let us speculate briefly about what these directions might be.

To begin with, within the G7 itself, the crisis has prompted public authorities to reconsider the confidence placed in the kind of market-based governance mechanisms that became so popular in the previous decade. The very institutions that were assigned formal regulatory roles – private banks, credit rating agencies, accountants – suddenly appear to be undeserving of the trust placed in them. Credit rating agencies are now criticized for having failed to understand the risks posed by the securitisation of poor quality US mortgages, and for being subject to multiple conflicts of interests. The internal risk models of the banks, a second input in the Pillar I in the Basle II Accord, have clearly proved to be flawed, especially during periods of crisis. Lastly, fair value accounting practices such as those supported by the IASB have been blamed of deepening the crisis, by creating strong procyclical effects in periods of disorderly financial markets. Even the bankers themselves seem to have lost faith in market-based regulatory approaches. As Joseph Ackermann, chief executive of Deutsche Bank, put it several days after the March 2008 bailout of Bear Sterns: "I no longer believe in the market's self-healing power" (quoted in Wolf 2008).

As the public sector is asked to bail financial institutions out, market-based regulatory approaches are more exposed to criticisms, and new actors enter the regulatory debate calling for the implementation of tighter public regulation. Foreseeing a possible regulatory clampdown, several financial industries have rushed to develop voluntary codes of best practices in order to restore their reputation and to head off a possible regulatory clampdown. The banking industry through the Institute of International

Finance, and the hedge fund industry through the newly created Hedge Fund Working Group in London and Asset Managers' Committee in the US have published their respective reports on best practices in response to parallel initiatives taken by the Financial Stability Forum (IIF 2008, HFWG 2008, AMC 2008). But it is not clear whether industry-driven initiatives will be effective this time in pre-empting public authorities from implementing more stringent and prescriptive regulations.

The extent to which the regulatory balance will move back towards the public sphere depends on the attitude of the public authorities in the G7 countries. Most of the time, financial regulators, especially in the US, have not been among those calling for more stringent regulation. Instead, they have been reluctant to resort to the regulatory toolbox too hastily, fearing that this could lead to the development of initiatives too burdensome for the industry. In order to protect the industry and itself from the calls for a "return of the state", the US Treasury has taken the initiative in creating a group of hedge fund managers in charge of designing a voluntary set of best practices, and it has announced the intentions to do the same in the case of the credit rating agencies and securitized credit products (President's Working Group, 2008). However, public authorities are less likely to rely on market-based initiatives in those industries where taxpayers are required to bail financial institutions out, or where investors have registered significant losses, such as in the cases of the banking industry. The more financial issues become politicized, the more the shadow of the state looms larger on market-based governance mechanisms, and the more a return of the state in the governance of financial markets is likely.

The return of the state in G7 countries may even extend to the regulation of cross-border financial investments. One of the ironies of the current crisis is that the SWFs of many developing countries are being called upon to recapitalize private financial institutions of the G7. The crises of 1994-2001 demonstrated the enormous power of Western private financial institutions to cripple the economies of developing countries. Now, the tables are turned, as these same countries come to rescue of Western institutions. Such a rapid turnaround of fortunes has inevitably provoked a political backlash within G7 countries among those who fear that SWF investments could undermine national sovereignty. If the SWFs do not agree to codes of conduct for their behavior, prominent G7 policymakers are threatening to limit their access into G7 markets.

Another result of the crisis is that the legitimacy of the G7-led standards and codes project is severely undermined elsewhere in the world. The crisis has raised serious questions about Anglo-American financial governance as a model. The very financial officials who lectured the EM countries on the inadequacy of their financial regulation are now embarrassed to find themselves subject to the same criticism by EM countries. In 1999 the G7 (1999) finance ministers were lecturing emerging countries with these words: "The recent crises have demonstrated the need for emerging market borrowers to strengthen their policy framework and financial systems if they are to reap the full benefits of integration into the international financial system". In the middle of the subprime mortgage crisis, it was now the G24 (2007) that could argue "developing countries are a new driving force as well as a stabilizing factor in the world economy… Ministers noted the vulnerability of the U.S. sub-prime mortgage market and its financial

and real spillover effects. They underscored the need to improve the Fund's surveillance of advanced economies, putting as much focus in evaluating their vulnerabilities as it does in emerging market economies."

This development is likely to accelerate the decentralizing trends in global financial governance that were becoming apparent in the years before the crisis. Already during the Basle II negotiations, Asian countries considered creating an alternative "Asian Basle" system because of their frustration with the lack of attention given to their concerns (Walter 2008: 181). This kind of proposal is likely to gain an even more sympathetic hearing now, as witnessed by the Japanese proposal in May 2008 to create an Asian version of the FSF.

These decentralizing trends may get one further boost if the crisis spreads to include a dollar crisis triggered by US external deficits and debt, a US recession, and fears of US financial instability and inflation. Such a crisis could undermine the dollar's role as a leading international currency in many parts of the world, particularly given the existence of the euro now as a viable rival international currency (Helleiner and Kirshner 2008). This trend, in turn, could strengthen those pushing for regional financial arrangements as alternatives to the US-dominated Bretton Woods institutions. In such a world, the need to develop cooperative governance mechanisms between regions – mechanisms that were perceived as legitimate to all actors involved - would become a pressing task. A reformed IMF could play a useful role in this context, but there are so few influential actors at the moment with a strong interest in promoting and backing the kind of serious IMF reform that would be necessary.

Each of these predictions could, of course, well turn out to be quite wrong. But what is certain is that the era described in the first two sections of this chapter has ended. Global financial governance in that era – an era of relative calm between the storms - was characterized by many diverse trends, but it was unified by the fact that all the actors involved had the common reference point of the crises of 1994-2001. The initiatives undertaken in response to those crises have left an important legacy as the world rides through a new set of financial storms. But the specific crises that triggered those initiatives are now an increasingly distant memory to those charting the trajectory of global financial governance today.

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[1] This view was not universal among G7 policymakers. Top Japanese policymakers, for example, were more inclined to blame the markets for the East Asian crisis and the content of their proposal for an Asian Monetary Fund in 1998- discussed later in this chapter - reflected this view.
[2] For the latter see http://www.treas.gov/press/releases/hp838.htm.