

## [Jeffrey Chwieroth](#)

# The crisis in global finance: political economy perspectives on international financial regulatory change

## Book section

**Original citation:**

Chwieroth, Jeffrey (2011) *The crisis in global finance: political economy perspectives on international financial regulatory change*. In: *Center for International Affairs*, (corp. ed.) *Beyond national boundaries: building a world without walls*. Academy of Korean Studies Press. ISBN 9788971058091

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Available in LSE Research Online: April 2012

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***The Crisis in Global Finance: Political Economy Perspectives on International  
Financial Regulatory Change***

Dr. Jeffrey M. Chwieroth  
London School of Economics  
Department of International Relations  
Houghton Street  
London WC2A 2AE  
Tel: [+44] (0) 20 7955 7209  
Fax: [+44] (0) 20 7955 7446  
Homepage: <http://personal.lse.ac.uk/Chwierot/>

This paper provides a political economy overview and analysis of the causes and consequences of the global financial crisis of 2007-2009. It begins with an examination of the reasons for the crisis and the response of governments to it. Close attention is paid to the recent sovereign debt problems in the West, particularly in the Eurozone, as well as the impact of the crisis in East Asia and its role in leading a multi-speed global economic recovery. The paper then explores the political implications of the crisis, focusing largely on the damage done to the pre-crisis balance of power and financial orthodoxy. The paper then explores the flurry of international regulatory initiatives that have emerged since the onset of the crisis and the results of the G-20 summits. The paper concludes by analyzing these results from a political economy perspective focused on the role of power, domestic politics, and ideas. The conclusion ends with a cautionary note about growing tendencies toward unilateral and regional action taken outside the G-20 process.

The global financial crisis of 2007-2009 has generated signs that the norms of financial governance are in flux, with many advanced market economies having implemented dramatic measures that at the time flew in the face of long-held policy beliefs. Central bankers and governments unleashed an extraordinary monetary and fiscal stimulus that saved the financial systems from collapse, but also pushed government budget deficits and debt profiles to the brink. Many governments, most notably those on the periphery of the eurozone, now find themselves in the throes of a sovereign debt crisis. Asia, on the other hand, has rebounded much more sharply from the global downturn that followed the collapse of Lehman Brothers in September 2008. Indeed, the world economy appears to be on course for a multi-speed recovery.

The crisis has resulted in a flurry of international regulatory initiatives. The reform agenda has been wide-ranging in scope. While many of the details are at this point unresolved and significant differences remain among key players, it is clear from the reform debate that many of the pre-crisis policy norms and regulatory templates have been discredited. The crisis has also accelerated the on-going shift in the balance of financial power and clout from West to East. Indeed, one of the most significant outcomes thus far has been the breakthrough in the form of international financial governance, which has led to the Group of 20 (G-20), rather than the Group of Seven (G-7), being convened to develop the reform agenda.

This paper examines these developments. It begins with an overview of the causes of the crisis and the policy response taken in advanced market and emerging market economies. It then explores the political implications of the crisis, focusing largely on the damage done to the pre-crisis balance of power and financial orthodoxy. It then turns to the results thus far from the G-20 summits. The paper concludes by analyzing these results from a political economy perspective focused on the role of power, domestic politics, and ideas. It suggests these factors are generating growing tendencies toward unilateral and regional action taken outside the G-20 process.

### **The Crisis: Impact and Policy Response**

The global financial crisis that began in the subprime market for asset back securities in the United States was the culmination of an exceptional boom in credit and debt. Several factors fueled the boom. Beginning the 1990s, most advanced market economies adopted independent central banks whose primary objective was price stability. Associated with the adoption of this policy framework was a dramatic improvement in macroeconomic performance in most countries, which led many to refer to this period of low economic volatility as the “great moderation.”

Yet this period of macroeconomic stability was accompanied by the build-up of financial imbalances. Many central banks in advanced market economies pursued exceptionally low interest rates in the context of low inflation and prolonged economic expansion in the early 2000s. At the same time, the recycling of savings and trade surpluses from China and other emerging market countries and oil-producing countries to the U.S. and other deficit countries served to compress yield curve spreads. Taken together, central bank policies and global macroeconomic imbalances generated historically low real interest rates and abundant liquidity, which increased the amount of debt and risk that borrowers, investors, and intermediaries were willing to take on. The result in many advanced market economies was housing bubbles of historic proportion.

Central bankers were aware of these asset price bubbles and that financial sector developments could pose macroeconomic risks. However, the increasing popularity of inflation targeting and blind spots in the macroeconomic models used for policy analysis and

policy formulation at most central banks, led few to take sufficient account of systemic risks stemming from rising leverage and asset prices. The widely shared “benign neglect” view, espoused most prominently by Alan Greenspan who served as chairman of the U.S. Federal Reserve from 1987 to 2006, led many central bankers to shy away from “leaning against the wind” by seeking to identify asset price bubbles and determining the proper way to deflate them before they burst.<sup>1</sup>

Proponents of the benign neglect view claimed it was too difficult to distinguish speculative manias from rational exuberance based on fundamentals. Moreover, it was felt that monetary policy was too blunt an instrument to counteract asset price bubbles and that financial stability was a task best left to regulators. If and when asset price bubble burst, the effects on the real economy could be largely counteracted, as they seemingly had been after the technology stock bubble had burst in 2001, though lower interest rates. For their part, many regulators, particularly those in the U.S. and Britain, embraced a “light touch” approach that relied on self regulation and market discipline to encourage innovation and to provide an effective check on risk-taking.

The build-up of an unusually high degree of leverage limited the system’s ability to absorb even small losses and would contribute to a rapid decline in confidence and increase in counterparty risk once the crisis began to develop. The build-up in leverage was not unique to advanced market economies. Some emerging markets developed a rising reliance on foreign financing, which left them vulnerable to a sudden stop and reversal in capital inflows.

Financial institutions responded to the great moderation by developing innovative models of securitization for mortgages and other assets. Traditionally, lenders bore the risk on the mortgages they issued. But the new originate-to-distribute model of securitization enabled financial institutions to transform their assets into asset-backed securities (ABS), and collateralized debt obligations (CDOs) that could be sold off to investors. Other financial innovations, such as credit default swaps (CDSs), which insured holders against defaults of various securities and structured credit products, also emerged. The result was an extraordinary expansion of the market for credit risk transfer instruments.

Banks and other financial institutions fueled this expansion by creating ABS-backed off-balance-sheet funding and investment vehicles (structured investment vehicles – SIVs), which tended to invest heavily in structured credit products. Many central bankers and regulators praised this new model of securitization, believing it to have strengthened systemic stability by diffusing risk and deepening the liquidity of the market for risk. Yet the model became increasingly dependent on originators’ underwriting standards, the risk and liquidity management practices of financial institutions, and the performance of credit rating agencies (CRAs) in evaluating risks inherent in ABS.

Moreover, much of the credit boom was associated with the creation of marginal assets whose viability depended upon continued favorable macroeconomic conditions. In the U.S., for instance, a large portion of the expansion of mortgage lending came from subprime borrowers whose ability to service this debt depended upon favorable macroeconomic conditions. In several Eastern European economies a large proportion of borrowing was denominated in foreign currency. While lower interest rates relative to those loans denominated in local currency increased affordability, borrowers’ ability to service their debt depended on continued exchange rate stability and favorable macroeconomic conditions.

Starting in the summer of 2007, a steady rise in U.S. subprime mortgage delinquencies triggered a sharp fall in the price for subprime ABS, which in turn produced

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<sup>1</sup> *The Greenspan Era: Lessons for the Future*, A Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, WY, 25 – 27 August 2005.

losses and margin calls for leveraged investors. The problems in the subprime market quickly spread to other markets. When CRAs announced multiple downgrades of formerly highly rated ABS, this caused a loss of confidence and broad reassessment of risk across the wide market.

In August 2007, money market investors in asset-backed commercial paper refused to roll over investments made in bank-sponsored SIVs backed by structured credit products. Banks became increasingly unwilling to provide liquidity to one another as they sold assets, cut lending, and increased their demand for liquid assets to repair their balance sheets and meet the funding commitments for their SIVs. As market liquidity evaporated, the interbank lending market and other credit markets froze.

As the credit crunch materialized, a vicious cycle developed. Faced with valuation losses and the need to make funding commitments, banks were forced to sell these hard to value distressed assets at fire sale prices, which in turn depressed asset prices further and generated additional valuation losses for assets that remained on balance sheets. This in turn forced additional asset sales that led to lower prices and further valuation losses and so on.

The use of fair value or mark-to-market accounting, which requires assets to be marked according to their current market value, reinforced this feedback loop by forcing banks to take immediate losses on their balance sheets after each price drop. As market liquidity for ABS evaporated, banks faced difficult challenges valuing their holdings and became less confident in their assessments about the exposure and capital strength of other institutions. Without any buyers for their distressed ABS, financial institutions were forced to absorb them onto their balance sheets, sustaining large losses to their capital cushions. Severe uncertainty developed about the soundness of individual financial institutions, the value of ABS, and the general macroeconomic outlook. This uncertainty, along with heightened risk aversion and reduced liquidity, caused financial intermediation in many advanced market economies to grind to halt.

In response to the crisis, policymakers from advanced market economies unveiled the largest Keynesian cocktail yet seen in peacetime. As the crisis has unfolded, the Bank of England (BoE), the European Central Bank (ECB), the U.S. Federal Reserve, and other central banks have responded by aggressively cutting interest rates, pumping larger amounts of liquidity into financial institutions on increasingly generous terms and across a wider range of collateral and counterparties, and introducing foreign exchange liquidity provision (i.e. “swap” lines). In an effort to unfreeze credit markets, some central banks have introduced credit guarantees and direct purchases of public sector and private sector securities. In terms of fiscal policy, some governments introduced discretionary measures to support aggregate demand while others relied more on automatic stabilizers to cushion the impact of the crisis. The largest fiscal outlay tended to come from discretionary measures to support the financial system such as debt guarantees, deposit insurance, distressed asset purchases and guarantees and interventions and recapitalizations of distressed financial institutions.<sup>2</sup>

For a while, emerging market economies, particularly those in Asia, appeared well placed to weather the crisis, as many were less exposed to the distressed ABS and enjoyed trade surpluses and a commodity price boom that continued through summer 2008. Some observers even speculated that emerging market economies could “decouple” from the downturn occurring in West. But after the crisis intensified following Lehman’s collapse in September 2008, arguments about “decoupling” proved premature.

After the financial storm swept across the Atlantic to Europe in late September, it moved on to affect emerging market and developing economies. While liquidity support, credit protection schemes, and bank recapitalization prevented a collapse of financial systems

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<sup>2</sup> International Monetary Fund, *Exiting from Crisis Intervention Policies* (Washington, DC: IMF, 2010).

in the West, emerging market and developing economies were now forced to deal with contagion from a crisis not of their own making. Many saw their stock exchanges and currencies plunge in value, as the risk appetite of investors declined, credit lines were cut, capital was repatriated to cover losses, and commodity prices fell because of plunging global demand. There were also complaints that some of the West's response to the crisis, such as political pressure on banks receiving taxpayer support to increase their domestic lending, was a form of financial protectionism that deprived emerging markets and developing economies of much needed credit. Many emerging market firms were hit with higher borrowing costs, limited opportunity to issue equity, and few alternative sources of financing. This sudden stop and reversal in capital inflows hit most emerging market economies. Among the hardest hit were those economies in eastern and central Europe where reliance on external financing had been high prior to the crisis.

In Asia, as demand wilted in the West, exports and industrial production collapsed. From late 2008 through early 2009 output growth decelerated quickly across the region – with Korea, most notably, experiencing its biggest quarterly decline in growth since the Asian financial crisis. Despite the growth of intra-regional trade, East Asia was unable to fully decouple from the business cycle of the West. This is because a large proportion of the trade within the region reflects intra-industry processing and assembly through vertically integrated supply and production chains that link to the West.<sup>3</sup>

Asian financial institutions did enter the crisis with limited exposure to distressed ABS, relatively healthy financial positions and strong capital buffers. But this did not insulate the region from the global financial turmoil.<sup>4</sup> As Asia's financial integration has increased over the past decade, so has its exposure to shifts in market sentiment. Foreign investors increased their holdings of Asian securities during the decade-long boom since the Asian financial crisis, thus leaving the region vulnerable to the significant outflows that occurred during the crisis. In addition, the increased reliance on international wholesale funding made Asian banks more exposed to the process of global deleveraging and the resulting shortage of dollar funding. Asian firms also increased their reliance on foreign funding (bond, equity and loan issuance) during the boom, leaving them exposed to the reduction in external financing, the tightening of corporate bond markets, and the drying up of trade credit.

Large stocks of foreign reserves did prove useful, but only up to a certain point. At the height of the financial turmoil, many governments were able to draw on their sizeable reserves to ease strains from the dollar shortages and slow down currency depreciations. But the high level of reserves did not fully insulate Asian economies from deterioration in growth. However, in contrast to Asian financial crisis, the accumulation of reserves did help many countries in the region avoid significant austerity measures and instead pursue fiscal and monetary easing in support of aggregate demand, though in most cases, with the exception of China, not to the same magnitude experienced in the West.

In the face of sudden stops and the collapse of export performance, many emerging market economies were, despite concerns about intrusive conditionality, forced to turn reluctantly to the IMF. After initially being somewhat irrelevant in helping the West resolve the credit crunch, the intensification and spread of the crisis in autumn 2008 thrust the IMF back into the lending business. Ukraine was the first country to receive a loan, in early

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<sup>3</sup> Prema-chandra Athukorala and Archanun Kohpaiboon, *Intra-Regional Trade in East Asia: The Decoupling Fallacy, Crisis, and Policy Challenges*, Asian Development Bank Working Paper No. 177 (Tokyo: Asian Development Bank Institute 2009).

<sup>4</sup> International Monetary Fund, *Regional Economic Outlook - Global Crisis: The Asian Context* (Washington, DC: IMF, 2009).

November. This program was soon followed with new programs with many borrowers in eastern and central Europe, South Asia, and Latin America.

The Fund, mindful of the criticisms of its response to the Asian financial crisis, has sought to overhaul how it lends money by offering higher amounts and tailoring loan terms to circumstances in the borrowing country. Unlike traditional IMF programs, the Fund has also developed a new lending instrument that provides resources unconditionally to select borrowers. Reminiscent of the now defunct Contingent Credit Line (CCL), a lending instrument the Fund developed in the aftermath of the Asian financial crisis, the new instrument is a precautionary lending program for countries with sound policies, not at risk of a crisis of their own making, but vulnerable to contagion effects from crises in other countries. Unlike the CCL, which was unsuccessful in attracting any borrowers because of a perceived stigma attached to it, the new IMF lending instrument has found greater success in getting countries to take out insurance in good times, with Mexico announcing in April 2009 that it had taken out a \$47 billion credit line – at that time the largest program in IMF history. Colombia and Poland also later agreed to similar precautionary arrangements. The Fund has designated as a high priority the overhaul of all its lending facilities.

The pressures from the crisis led the Fund to commit to disbursing a record level of lending. Heightened demand for IMF lending subsequently fostered new concerns over whether IMF resources, which stood at around \$250 billion in October 2008, were sufficient should additional borrowers emerge. In April 2009, the G-20 sought to meet potential future demand on IMF resources by committing to a \$750 billion increase in its resources.<sup>5</sup> The new resources have since come in several forms, with \$500 billion coming from bilateral loan agreements and an enlargement of existing arrangements that permit the IMF to borrow from some of its leading members. An additional \$250 billion has come in the form of an exceptional Special Drawing Right (SDR) allocation. Although pleased by the commitment to increase IMF resources, officials in emerging market economies, particularly large reserve-holding countries, such as Brazil, Russia, India, and China—the so-called BRICs—fear that there will be pressure to contribute ad hoc increases now against promises of governance reform in the future. They therefore have made their contribution through newly created IMF bonds, while still pushing strongly for governance reform, which the G-20 has committed to accelerate.

Heading into the November 2010 G-20 leaders summit, the IMF is seeking additional commitments to boost its lending resources to \$1 trillion to build safety nets that could prevent financial crises. As part of its ongoing efforts to overhaul its lending, the IMF wants to offer loans agreed in advance and specifically tailored to individual countries to dampen market fears about an economy facing a liquidity crisis. As current chair of the G-20, South Korea, which had to tap swap arrangements from the U.S., Japan, and China to rescue itself from a dangerous liquidity shortfall in 2008 (see below), is helping to craft to plan. Proposals currently under consideration would create multiple-tiers of credit lines with countries qualifying with certain types of financing programs depending where they were on a risk curve, with the least risky being entitled to financing with little or no conditionality and countries further down the curve facing tougher conditionality.

Sizeable reserves and lingering concerns about intrusive conditionality meant that no East Asian government approached the IMF for financing. Interestingly, East Asian emerging market economies turned to self-help and bilateral tools, rather than regional alternatives, to stabilize their economies. Most notably, despite great fanfare attached to the process of enlarging and multilateralizing the Chiang Mai Initiative of bilateral currency swaps, governments, such as Korea and Singapore, turned to negotiating new \$30 billion

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<sup>5</sup> G-20 London Summit Communiqué (2 April 2009).

currency swap lines with the U.S. Federal Reserve rather than relying on existing regional arrangements.<sup>6</sup> For Korea, the swap line with the Federal Reserve proved more effective in easing foreign currency liquidity constraints than swaps set up by the Bank of Korea using its own foreign reserves.<sup>7</sup> Korea's experience with the swap line with the Federal Reserve underscores the point made earlier that reserve accumulation has proven useful only up to a certain point. Moreover, as noted, the liquidity pressures it faced, which produced a collapse in equity and currency markets, has been a key motivating factor behind the government's desire to steer the G-20 toward strengthening financial safety nets.

In the end, the extraordinary monetary and fiscal easing undertaken in the face of the crisis was successful in stabilizing the financial system. The "Great Recession," though the deepest since the Second World War, did not become another "Great Depression." The world economy turned the corner by mid-2009, though there is still a long way to go before the recovery is fully entrenched. Emerging market economies felt the effects of the global crisis later than the West, experienced a milder slowdown, and have recovered more sharply. Indeed, the world economy is recovering from the crisis at different speeds in different parts of the world. Asia is leading the global multi-speed recovery and is likely to continue to do so in 2010-2011.<sup>8</sup>

In the West the key macroeconomic task is to reduce the rise in sovereign risk that has developed from the rapid increase in public debt and deterioration of fiscal positions that came from discretionary measures to support aggregate demand and the financial sector. Emerging market economies are generally better placed since they suffered small output losses and lower deficits during the crisis, and thus far have experienced a strong recovery. As epitomized by developments in Greece and across the Eurozone, there is greater concern in the West that the banking crisis is now evolving into a sovereign debt crisis. In addition, there are still worries that many banks across the Eurozone have not yet adequately deal with the distressed assets on their balance sheets.

Concerns about the deterioration of the fiscal outlook in many advanced market economies led to the G-20 to reverse course in June 2010 by emphasizing that they no longer thought that expansionary fiscal policy was sustainable or effective in fostering an economic recovery because investors were no longer confident about some countries' public finances. Unwinding the stimulus and engaging in fiscal consolidation will prove challenging, as policymakers seek to balance concerns about withdrawing measures too soon and pushing their economies back into recession against worries about withdrawing measures too late and stoking inflationary pressures. Moreover some countries, most notably the U.S., continue to emphasize the need for fiscal expansion, particularly by countries such as Germany and China, which have large and protracted payments surpluses.

Among most advanced market economies, interest rates are expected to remain low for an extended period.<sup>9</sup> Some liquidity and credit easing measures introduced during the crisis have been terminated or permitted to expire, though the crisis in Greece and across the Eurozone has forced the ECB to reverse its earlier commitment to wind down some support measures and even led it to expand its operations by purchasing for the first time public sector securities. Some emerging market economies, particularly those in Asia where the

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<sup>6</sup> Korea also negotiated a three-year currency swap of RMB180 billion (\$US 26.3 billion) with China and a two-year \$US 20 billion swap with Japan. Singapore arranged an additional swap with Japan. Brazil and Mexico also negotiated swap lines with the U.S.

<sup>7</sup> Naohiko Baba and Ilhyock Shim, Policy Responses to Dislocations in the FX Swap Market: The Experience of Korea, *BIS Quarterly Review* (June 2010): 29-40.

<sup>8</sup> International Monetary Fund, *World Economic Outlook* [April edition] (Washington, DC: IMF, 2010)

<sup>9</sup> Australia and Canada, whose banking systems remained healthy during the crisis and are currently enjoying a strong recovery, are notable exceptions to this trend and have begun to tighten monetary policy.

recovery has taken hold and inflationary pressures are developing, have taken measures to tighten monetary policy. The ample supply of global liquidity, significant interest rate differentials between them and the West, and brighter growth prospects are driving capital inflows into the region, stoking concerns about inflation and asset price bubbles. In response, many governments have introduced new regulatory measures, discussed below, in an effort to safeguard macroeconomic and financial stability.

### **Political Implications of the Crisis**

The crisis has had significant implications for the politics of international financial regulation. First, as the leading advocates of light touch regulation, the crisis has clearly put the U.S. and Britain, and the institutions based in their financial centers, on the defensive. More specifically, it has seriously undermined the legitimacy of the self-regulatory norm upon which much of the Anglo-American model was based. Initially, some such as Greenspan sought to defend this policy norm. But following the intensification of the crisis in September 2008, even Greenspan was forced to concede, “I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders.”<sup>10</sup>

At first some European officials, could hardly hide their delight at the U.S. misfortune as they watched the storm brew in the centre of the financial system. For these officials, the events of mid-September 2008 in the U.S. - the government takeover of Fannie Mae and Freddie Mac, the government arranged private sector sale of Merrill Lynch, Wachovia, and Washington Mutual, the bankruptcy of Lehman Brothers, and the government rescue of AIG – strengthened their conviction that the U.S. had been wrong to resist their calls over the last decade to tighten regulation. Peter Steinbrück, then German finance minister, claimed that the U.S. belief in “laissez-faire capitalism; the notion that markets should be as free as possible from regulation; these arguments were wrong and dangerous. This largely under-regulated system is collapsing today.” Reregulation, not self-regulation, Steinbrück insisted, would become the new policy norm, and governments must act to “civilize financial markets.”<sup>11</sup> French president Nicolas Sarkozy, similarly declared, “The idea of an all-powerful market without any rules and any political intervention is mad. Self-regulation is finished. Laissez faire is finished. The all-powerful market that is always right is finished.”<sup>12</sup> Sarkozy called for a summit of world leaders to be convened aimed at building a “regulated capitalism...in a way to allow European ideas to flourish.”<sup>13</sup>

Former British prime minister Gordon Brown also sought to position himself as the scourge of unfettered capitalism, noting that 2008 would be remembered as the year in which the “old era of unbridled free market dogma was finally ushered out.”<sup>14</sup> In its March 2009 report on the causes of the crisis, the Financial Services Authority (FSA), Britain’s financial regulator, similarly observed that the crisis “raises important questions about the intellectual assumptions on which previous regulatory approaches have been built [and in particular] the theory of efficient and rational markets.”<sup>15</sup> Adair Turner, chair of the FSA, has gone so far as

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<sup>10</sup> As quoted in Alan Beattie and James Politi, “‘I Made a Mistake’ Admits Greenspan,” *Financial Times*, 23 October 2008.

<sup>11</sup> As quoted in Bertrand Benoit, “US ‘Will Lose Financial Superpower Status,’” *Financial Times*, 25 September 2008.

<sup>12</sup> As quoted in John Thornhill, “Sarkozy Sets Out Bigger State Role,” *Financial Times*, 25 September 2008.

<sup>13</sup> As quoted in Harvey Morris, “Sarkozy Presses for Capitalism Summit,” *Financial Times*, 24 September 2008 (“regulated capitalism”); Ben Hall, “Eurozone Set to Pledge Billions in Rescue Bid,” *Financial Times*, 12 October 2008 (“European ideas”).

<sup>14</sup> As quoted in Jim Pickard, “Brown Promises Stability in Difficult Year,” *Financial Times*, 1 January 2009.

<sup>15</sup> Financial Services Authority, *The Turner Review*, p. 39.

to label Britain's reliance on light touch regulation and self-regulation as a "fundamental intellectual failure."<sup>16</sup> The new Liberal Democrat-Conservative coalition government, elected in May 2010, has pledged tougher regulation, but the degree of support from Britain for such initiatives at this point remains unclear. Britain has typically sided with the U.S. in opposing heavy handed regulation and has worked hard to deflect efforts to extend European financial regulation to the City of London.

It is clear from the policy response of and statements from public officials in the West that the prominent diagnosis informing the current reform debate is strikingly different from the one offered following the emerging market crises of the late 1990s. Prior to the onset of the recent crisis, the tacit presumption of the G-7 and the IMF was that the primary source of financial instability lay in emerging market and developing economies. Regulation to reduce negative externalities emanating from the financial centers of advanced market economies was eschewed in favor of an approach that placed the bulk of the blame for the 1997-98 Asian financial crisis (and later crises in Russia and Latin America) on policy errors and institutional deficiencies in crisis-afflicted countries.<sup>17</sup>

In response, the IMF offered large financing packages, but with stringent conditionality. Private market actors, most of who were based in financial centers in advanced market economies, were relieved of most of the blame and were not subject to tighter regulation. On the contrary, faith in markets led governments over the next decade to assign to private market actors an increasingly significant role in the regulation and supervision of financial markets. The G-7 sought to correct errors and deficiencies in crisis-afflicted economies by encouraging them to adopt various international financial standards and codes. Most of these standards and codes were informed by the interests and experiences of G-7 countries, and in particular the Anglo-American regulatory approach, and virtually excluded emerging markets and developing economies from much input into their design.

This diagnosis of the emerging market crises of the 1990s was never universally shared. Many emerging market and developing economy officials, particularly in East Asia, objected to this diagnosis and instead blamed financial instability more on the vagaries of free market finance. Emerging market officials also resented being encouraged to adopt standards and codes developed in bodies in which they had little or no input. These standards and codes were perceived as inappropriate to their contexts and/or serving the interests of the West. Rather than fully implementing the standards and codes backed by the G-7, many instead pursued a policy of weak or "mock compliance."<sup>18</sup> Many emerging market officials also drew the lesson that measures needed to be taken to minimize their vulnerability to global financial markets and to the IMF, whose advice and conditionality was widely perceived in Asian policymaking circles as aggravating the crisis. As a result, many countries used the long global economic expansion that preceded the recent crisis to accumulate reserves and to pay off outstanding debts to the IMF. Self-insurance via reserve accumulation, rather than collective insurance via the IMF, became widely practiced. Regional liquidity measures, such as the Chiang Mai Initiative, also were developed as a way of reducing external vulnerability.

In contrast to the period following the Asian financial crisis, in the current reform debate there is a strong consensus that the same market participants who over the past decade had been permitted to self-regulate were responsible for triggering the crisis. Financial markets are now being re-regulated because politicians either blame markets or because they

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<sup>16</sup> As quoted in Jennifer Hughes, "UK Banks to Face Tougher Rules," *Financial Times*, 25 February 2009.

<sup>17</sup> Jeffrey M. Chwieroth, *Capital Ideas: The IMF and the Rise of Financial Liberalization* (Princeton: Princeton University Press, 2010).

<sup>18</sup> Andrew Walter, *Governing Finance: East Asia's Adoption of International Standards* (Ithaca: Cornell University Press, 2008).

recognize that large rescues of financial institutions would not be politically acceptable to taxpayers without some reassurance that such institutions will be subject to tighter regulation. The IMF, for its part, has developed new unconditional lending facilities that are meant to ensure against crisis. Taken together, these developments represent a shift in the way financial crises are understood. The current consensus has shifted from a view that sees crises largely as homegrown, to a view that allows for the existence of externally induced crises that can spread to otherwise sound economies.

The need to minimize negative externalities emanating from financial centers in advanced market economies is now widely accepted. Belying the tacit assumption that prevailed following the Asian financial crisis, the origin of this crisis was found in those countries at the centre of the global financial system. The severe effects of the crisis, along with the massive taxpayer rescue of the financial system, have generated significant popular backlash against financial institutions and the policy norms they championed. This popular backlash has generated unprecedented political pressure within the U.S. and Britain to tighten financial regulation.

That the United States and Britain implemented what effectively was a partial nationalization of their financial systems is a striking indication of how the crisis has undermined long-held policy norms. Indeed, it is remarkable the extent to which the G-7 response to the crisis has turned orthodoxy on its head. Over the past decade the G-7 had lectured crisis-afflicted countries on the need to restore confidence by closing insolvent financial institutions, strengthening fiscal discipline, and raising interest rates. Then, when faced with a crisis in their financial systems, G-7 countries pursued precisely the opposite policies.

This fact, and the damage done to U.S. and British financial leadership, was not lost on many emerging market officials, who were quick to turn the tables on the G-7. "Allow me to point out the irony of this situation," stated Brazil's finance minister: "countries that were references of good governance, of standards and codes for the financial systems," were now the same countries where financial problems were raging.<sup>19</sup> Or, as one Chinese official recently put it, "We used to see the U.S. as our teacher but now we realize that our teacher keeps making mistakes and we've decided to quit the class."<sup>20</sup> Emerging market officials have become increasingly assertive in taking to lecturing advanced market economies about the problems with their pre-crisis regulatory models. One senior Chinese financial regulator has argued that "the western consensus on the relation between the market and the government should be reviewed. In practice, they tend to overestimate the power of the market and overlook the regulatory role of the government and this warped conception is at the root of the sub-prime crisis."<sup>21</sup>

The current crisis has certainly delivered a damaging blow to the prestige and cachet of the Anglo-American regulatory model. Following the largest government intervention in the economy since the New Deal, it has become increasingly difficult for the U.S. to sell market-oriented policy norms. Until the crisis, it was possible to hold up the U.S. and British systems as a model for other countries to emulate. But the crisis has made it hard for the U.S. and Britain to persuade other countries that its failures were not due to the policy norms they championed.

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<sup>19</sup> As quoted in Steven R. Weisman, "Tables Turned: Poor Countries Wage Fingers at Rich Ones," *New York Times*, 22 October 2007.

<sup>20</sup> As cited in Eric Helleiner, "A Bretton Woods Moment? The 2007-2008 Crisis and The Future of Finance," *International Affairs*, 86 (3):619-636 at p. 629.

<sup>21</sup> As quoted in Jamil Anderlini, "China Says West's Lack of Market Oversight Led to Subprime Crisis," *Financial Times*, 28 May 2008.

Is this crisis a “critical juncture” in which the world now moves away from the policy norms that have underpinned the financial system for over two decades? Some prominent observers believe this to be the case. Harold James, for instance, notes, “The response to the Asian crisis of 1997–98 was the reinforcement of the American model of financial capitalism, the so-called Washington Consensus. The response to the contagion caused by the U.S. subprime crisis of 2007–8 will be the elaboration of a Chinese model.”<sup>22</sup>

While the legitimacy of the Anglo-American regulatory model has been called into question, it is still far from clear what, if anything, will replace it as the basis for widely shared policy norms. The Asian financial crisis initially sparked much interest in radical reform. Yet once the severity of the crisis passed, and the resolve of advocates of liberalization and self-regulation stiffened, support for radical reform faded. Instead, we witnessed a drive, as James suggests, that reinforced Anglo-American financial hegemony through the development of standards and codes. We may yet witness a similar evolution in the current reform debate. At present, current reform initiatives, as Helleiner notes, “represent more continuity than dramatic change in the sense that they build upon the international regulatory project that the G-7 promoted in the wake of the 1997–98 crisis.”<sup>23</sup>

Rather than producing more continuity, the damage done to the Anglo-American hegemony could usher in a new era of diversity; one that goes against the universalist tone of the standards and code project. If the reforms under consideration fail to meet the expectations of key officials, then, as Helleiner suggests, we could see such “centrifugal tendencies” in international financial regulation grow in intensity with governments increasingly staking out unilateral and regionally-defined norms of financial governance. Indeed, in the current debate governments at times, often in response to domestic political pressure, have shown themselves willing to chart an increasingly independent course of action that threatens to undermine efforts at multilateral coordination and the universalist nature of the standards and codes project. As Helleiner notes, if this route is taken, “We will be moving towards a more decentralized regulatory order, one which is more compatible with diverse forms of capitalism but which might also sit less comfortably with entirely liberal regime for the movement of capital and financial services.”<sup>24</sup>

In addition to damage done to Anglo-American intellectual hegemony and leadership, the crisis has also accelerated the gradual shift in financial wealth and geopolitical clout away from the West to new emerging powers. One striking indicator of this shift was the way US and European officials enthusiastically welcomed investment from emerging market sovereign wealth funds to support distressed Western financial institutions in 2007-08. Another indicator is the growing financial clout of China. In early 2010, by market capitalization, China had three of the four largest banks, the two largest insurance companies, and the second-largest stock market.<sup>25</sup> The crisis has also brought into sharper relief the financial dependence of the US on support from China and other emerging markets. With their massive holdings of U.S. dollar assets, these countries have become increasingly assertive in seeking reassurances about U.S. fiscal policy and in questioning the dollar’s role as the principal international reserve asset.

These challenges to the pre-crisis status quo set the stage for the convening of several summits of the leaders of the G-20, what some ambitiously billed as “Bretton Woods II.”

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<sup>22</sup> Harold James, “The Making of a Mess: Who Broke Global Finance, and Who Should Pay for It?” *Foreign Affairs* 88, no. 1 (2009), pp. 162-168 available at <http://www.foreignaffairs.com/articles/63590/harold-james/fixing-global-finance>.

<sup>23</sup> Eric Helleiner, “Crisis and Response: The Story So Far: Five Regulatory Agendas in Search of an Outcome,” *International Politics and Society*, 1 (2009): 11-26 at p. 24

<sup>24</sup> Helleiner, “Crisis and Response,” p. 23.

<sup>25</sup> “Red Mist,” *Economist* (4 February 2010).

These summits have marked recognition of the growing power of emerging markets in the world economy and the beginning of efforts to broaden the inclusiveness of global financial governance. Prior the onset of the crisis, global financial governance had taken place largely within fragmented and exclusive policy networks dominated by advanced market economies. The G-7 largely sidelined international institutions, such as the IMF, from the standard setting process. The Financial Stability Forum (FSF), created in 1999, was charged with the task of coordinating the standard setting process, though it lacked the type of supranational powers granted to the World Trade Organization and served more as a forum for facilitating networks of informal cooperation, information-sharing, and consensus-building. With the exception of Hong Kong and Singapore, emerging market economies were excluded from membership in key standard setting bodies.

Yet the first summit of G-20 leaders in November 2008 signaled an important break from this more exclusionary framework, though some claim more can be done to increase representation from low-income developing countries.<sup>26</sup> The presence of leaders from emerging markets at the summit, which was initially marked by a low profile but has seen increasing assertiveness over time, has offered a symbolic breakthrough in form and has opened up the possibility for future substantive breakthroughs in which the interests and experiences of emerging market economies come to be more adequately reflected in international regulatory outcomes. The G-20 immediately took over the mantle of leadership from the G-7 and moved quickly to insist upon broadening the inclusiveness of other standard-setting bodies.

### **The G-20 and the Politics of International Financial Regulation**

The summits have considered a reform agenda that has been wide-ranging in scope. Since early 2008, the FSF has led the way in providing a series of reports setting out a regulatory agenda for responding to the crisis. In April 2009, the G-20 gave the FSF an even stronger mandate and renamed it the Financial Stability Board (FSB). The diagnosis of the FSF/FSB reports has generally pointed to the need to modernize and tighten outdated and inadequate financial regulation. Securitization, which transfers credit risk to parties far from the original source, had obscured the ability and weakened the diligence of market participants, regulators, and CRAs to monitor and evaluate risk. Light touch regulation and a belief that securitization had enhanced systemic risk and deepened market liquidity had led many aspects of the securities market left with little or no regulation.

After the onset of the crisis, the opaqueness and dispersion of risk intensified the loss of confidence and uncertainties about the exposure of financial institutions to particular assets. “Over-the-counter” (OTC) derivatives, and credit default swaps (CDS) in particular, proved to be particularly opaque and to pose enormous challenges. These derivatives, which are negotiated privately off exchange and without a centralized clearinghouse that can minimize counterparty risk and force margin requirements for all contracts, had been left unregulated over the last decade. During the crisis these derivatives were at the heart of AIG’s near collapse, and heightened market panic after the collapse of Lehman, as market participants and regulators struggled with uncertainty about the amount of CDS issued on Lehman debt.

The development of off-balance sheet vehicles, which banks used to evade capital regulatory requirements, also created concerns. This “shadow banking system” and other financial institutions, such as investment banks and hedge funds, became increasingly

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<sup>26</sup> United Nations, *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System* (New York: United Nations, 2009).

entangled in the financial system. Although the systemic importance of these institutions meant that many enjoyed implicit state support, they were not covered by the same regulations as commercial banks. When one of these institutions, Bear Stearns, became “too entangled to fail” and taxpayer money was used to rescue it in March 2008, the event focused the attention of U.S. officials (and others) on broadening the regulatory perimeter to cover investment banks and other entities with implicit state support. The size of these firms also exposed the need to tackle firms that were “too big to fail” (TBTF) or in the case of some countries such as Iceland (and even Britain and Switzerland), where the assets of some financial institutions dwarfed the size of tax revenues, “too big to save.” Consolidation in the financial sector since the crisis has made this issue an even more pressing concern.

During the course of the crisis, the FSF outlined over sixty recommendations to modernize and broaden financial regulation.<sup>27</sup> Many of these recommendations are consistent with initiatives currently being implemented or considered within the U.S., Britain, and the European Union. However, as highlighted below, across a wide range of issues, national regulators and legislators are going down different avenues from their G-20 colleagues. Coordinated multilateralism has thus occasionally fallen prey to unilateral initiatives taken in the “national interest.”

The most important bit of reform, outlined by the Basel Committee on Banking Supervision (BCBS), is the new proposed international set of rules known as “Basel III,” which will govern the capital and liquidity buffers banks carry.<sup>28</sup> Basel II, which was being implemented when the crisis broke, replaced the Basel (I) Accord, an agreement that emerged during the 1980s debt crisis in response to lax banking standards in many advanced market economies. The principal innovation of Basel I was the development of a standardized risk-weighting scheme that requires banks to set aside varying levels of capital depending on asset risk. Initially proposed in 2004, Basel II epitomized the general post-Asian financial crisis trend that assigned a greater role for private market actors. Regulator responsibility for monitoring markets shifted to private market actors through greater disclosure and market discipline. In fact, market discipline was elevated to one of the three “pillars” of the Basel Accord, alongside capital requirements and supervision. Basel II provides for greater flexibility than Basel I by permitting larger banks to use their own information and internal risk models to develop their own risk-weightings. Smaller bankers are to use risk-weights based on ratings issued by CRAs.

Some argue that the entire Basel II framework should be scrapped, as the crisis has discredited its chief innovations of relying on relying on the internal risk management of large banks and on CRAs. But rather than scrap Basel II completely, Basel III, unveiled in December 2009, generally seeks to close its loopholes, focus more on systemic risks, and strengthen transparency and risk management. Overall, Basel III offers a modest reform agenda, one that seeks to update the existing regulatory framework but that has thus far stopped short of more radical regulatory measures.

Under the initial proposals, banks were to be required to set aside more capital against complex structured products, off-balance sheets vehicles, and trading book instruments. Banks were also for the first time to be forced to follow new guidelines on liquidity management to respond to sudden changes in market liquidity that had left some banks, most notably Northern Rock and Bear Stearns, short of funding during the crisis. The initial Basel III proposals also aimed to tighten requirements on the definition of capital. The definition of capital under Basel II permits banks to include hybrid instruments – part debt, part equity –

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<sup>27</sup> Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (Basel: Financial Stability Forum, 2008).

<sup>28</sup> BCBS, *Strengthening the Resilience of the Banking Sector* (Basel: BIS, 2009); BCBS, *International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Basel: BIS, 2009).

to count as core capital. Yet this hybrid capital, which was more widely used in the EU than the U.S., proved less effective in absorbing losses than common equity, which, under the initial Basel III proposals, would form the bulk of bank capital.

As a way of dealing with the TBTF problem, systemically important firms may be assessed a capital surcharge and at a minimum be subject to enhanced prudential supervision. In a clear acknowledgement that relying too heavily on banks' internal risk models was a mistake, the initial proposed rules will be supplemented by a "leverage ratio" not weighted to risk that places limits on the amount of debt banks can build up relative to their capital cushions. The aim of the measure is partly to curb leverage and partly to prevent gaming of risk-based requirements: European banks, which unlike American ones, are not subject to a leverage ratio, took on higher levels of debt because many of their assets were highly rated securities with low risk weightings that turned out to be of dubious quality.

While the private market actors accept in principle the objective of increasing capital buffers, they have complained that strengthening the quantity and quality of capital buffers will increase the cost of lending and serve as a drag on growth. Private market actors also have chafed at the liquidity proposal that will require them to wean themselves off cheaper short-term funding and rely on more costly long-term funding. Banks have launched a large lobbying effort to press their case for less stringent regulations, offering their own impact studies that suggest great economic harm would result from too stringent rules. For regulators, the trick is setting the amount of capital that is needed in the system and defining a tolerable amount of short-term funding; for politicians and voters, it is striking and deciding upon the right balance between growth and stability.

The Basel III proposals are to be finalized this year after a BCBS impact study. Implementation was initially scheduled to occur at the end of 2012, but this timing has recently been called into question, with the June 2010 G-20 leaders' summit watering down this target.<sup>29</sup> Differences among key G-20 members (see below) and industry lobbying have led G-20 to admit implementation is likely to be phased in over a longer time than originally planned. For instance, the requirement that banks must set aside more capital against trading book instruments, originally scheduled to come into force in January 2011, has now been delayed until the end of that year. Privately, some sources indicate that Basel III will likely not be put in place until between 2014 and 2016.

By late July 2010 it became clear that the banks had won the argument over the strictness and timing of the initial Basel III proposals. The BCBS announced that it had softened some of its initial proposals and delayed others to at least 2018. The BCBS delayed several of its more innovative and stringent proposals. The planned liquidity guideline proposal, which would have imposed significant costs on banks, will be in an "observation phase" until at least 2018 and will likely be modified substantially. The BCBS is also taking a more deliberate approach in introducing the new leverage ratio, which is designed to prevent banks from using off-balance-sheet vehicles and risk-weighting methods to hide the true size of their balance sheets. The new leverage ratio, which would require banks to hold high-quality capital equal to 3 per cent of unweighted assets, will be in a test phase until the end of 2017. In addition, the BCBS eased up on its definition of what constitutes as a liquid asset and high-quality capital. The biggest effect of these proposals will depend on the BCBS's next decision, due this autumn, which is to set the minimum required ratio of high quality capital to risk-weighted assets. The higher the ratio, the bigger the expected impact.

The U.S. and EU have been in broad agreement on imposing more conservative capital and liquidity requirements. Still, there are important disagreements and there have been some tendencies toward unilateral action. The most important disagreement divides a

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<sup>29</sup> G-20, Toronto Summit Declaration (26-27 June 2010).

bloc of countries that includes the U.S., Britain and Switzerland from one that includes Germany, France and Japan. The first group has been enthusiastically behind a substantial increase in capital ratios coupled with a more conservative assessment of what counts as capital, tough liquidity rules and a new simple leverage ratio. The second group has been more attached to the pre-eminence of the current risk-based approach and wants the leverage ratio to have a much less important role in governing banks' balance sheets. The political atmosphere in the U.S. is much more geared toward preventing future taxpayer rescues and eliminating implicit state support for TBTF institutions. In Germany and France, where taxpayer rescues have not been as large and where politicians and voters are much more comfortable with having the state as a potential backstop, there is less support for strengthening the quantity and quality of capital. Germany and France are also concerned about the timing for implementation, since problems in the banking sector in Europe have yet to be resolved to the same extent as in the U.S. and Britain. Much will depend on whether recently completed stress tests on European banks, which have been widely perceived as being rather lenient, restore market confidence in the long run. (The U.S. and Britain published results of their stress tests in spring 2009.)

Some of these divisions are also a result of the worries about the disparate costs that would be imposed on banks as they seek to meet the new Basel III requirements. Since German, France, and Japanese banks rely more on hybrid capital and were more highly leveraged prior to the crisis than their American counterparts, the scale and costs of the adjustment required will likely be much higher. Heightening the political ramifications of these discussions is the fact that European banks play a much larger role in local economies than their U.S. counterparts. Some banks would likely be forced to cut their balance sheets or use a large proportion of their profits to build up capital. Other banks that weathered the crisis relatively well, such as those in France and Japan, chafe at being caught in the backlash against less prudent lenders. These concerns have found a sympathetic ear among policymakers and regulators who remain concerned about how regulation will affect the competitiveness of their banks. Indeed, many of the July 2010 concessions on Basel III, such as easing the definition of what constitutes high-quality capital and a lower than expected leverage ratio, have been to the benefit of German, French, and Japanese banks.

Not surprisingly, the slow pace of reaching international agreement on Basel III, and the potential for some proposals to be watered down, has tempted some countries to pursue unilateral action. For instance, rather than wait for international agreement to be reached on the Basel III proposals, in July 2010, the US passed financial reform legislation that will prevent bank holding companies from using certain types of preferred securities to count towards their core capital.

In addition to strengthening capital and liquidity buffers, the Basel III proposals have revealed an important philosophical shift toward new measures that will lean against "procyclicality," or the tendency of regulations to amplify the boom and bust cycle by contributing to the expansion of lending during economic upturns and the collapse of lending during downturns. Prior to the onset of the crisis, regulations in most countries enabled banks to set aside less capital in good times as asset prices increased and perceived risk and anticipated losses declined. In bad times, when asset prices fell and risk and losses mounted, banks scrambled to raise capital. Accountants contributed to this problem, frowning then and now on setting aside reserves ("provisioning") during boom-times as possible profit-smoothing in disguise. To combat these pro-cyclical tendencies, the Basel III proposals suggest mitigating procyclicality by introducing capital requirements that vary over the economic cycle (rising in good times, declining in bad times) and, following the widely-heralded example of Spain, the use of dynamic provisioning, which would require banks to

set aside capital for the statistically expected level of future loan loans over the full economic cycle not just the current climate.

Outside the Basel III process, the G-20 has also sought to address the procyclicality of fair-value accounting rules. Critics, most notably French president Nicholas Sarkozy, complain that usage of fair value accounting amplified the effects of the crisis by forcing banks to mark down assets to values that prevailed in a period of extreme distress. Those in favor of fair value accounting, among them Goldman Sachs and a host of powerful U.S. mutual and pension funds, argue that valuing assets and loans at market prices is in the best interests of the investors by providing the clearest view of a company's worth.

The G-20 has also asked accounting standard setters to improve guidance for the valuation of assets in illiquid markets and to converge towards a single high-quality standard. Currently, the standards set by the International Accounting Standards Body (IASB) are employed by over one hundred countries, including the EU, while the Financial Accounting Standards Board (FASB) sets standards for the U.S. and a few other countries.

At the height of the crisis, both the IASB and the FASB, under political pressure, agreed to relax some fair value rules. Yet recent proposals from both bodies suggest that the FASB is more wedded to the wider use of fair value accounting than the IASB. This divergence has come in large part from strong political pressure from Europe to limit the use of fair value accounting. The IASB has sought to bow somewhat to these political pressures by releasing revised guidance that retained the use of fair value accounting for all financial instruments outside of loans and loan-like instruments. But this concession did not go far enough for the European Commission, which, in November 2009, refused to adopt the revised guidance. The European Commission has gone so far as to suggest that future EU funding for the IASB would be in jeopardy if it did not bow to political pressure to change its guidance.

But the IASB has found backers in other countries such as Japan, which recently included the IASB's latest revisions in a package of guidance made available for use by some Japanese firms on a voluntary basis from March 2010. For the IASB, this has set up a clash not only with European officials but also with the FASB, whose recent guidance, issued in May 2010, seeks to extend the use of fair value accounting. Given that the European Commission has opposed the IASB's recent proposal, it seems certain that European politicians and regulators will take an even dimmer view of the FASB plan. The achievement of a single global accounting standard by the June 2011 deadline set by the G-20 now looks nearly impossible to achieve.

Efforts to address pro-cyclicality and the TBTF problem fall within the broader shift away from micro-prudential regulation and toward macro-prudential regulation. The micro-prudential philosophy that prevailed prior to the onset of the crisis directed regulators to focus on firm-level supervision in the formal banking sector, the presumption being that if each individual bank is safe, then the system as a whole will be too. Yet this philosophy gives insufficient attention to severe problems that can arise through the correlation of risks across banks, which are presumed to be independent. The problem with the microprudential philosophy is a fallacy of composition: It may be prudent, for instance, for an individual bank to sell assets when price of risk increases. Yet if many banks do the same, the price will collapse; causing banks to take further steps that create downward price spirals such as those that developed in the crisis.

An alternative "macro-prudential" ethos stresses systemic risks and is less concerned with the risks to and failure of individual banks per se and more with the correlation of risks across banks and the macroeconomic costs of financial instability as the basis to formulate policy. A macro-prudential orientation recognizes how financial instability can result from common exposures to similar assets across the system and therefore pays greater attention to

pro-cyclical tendencies. A core element of macro-prudential regulation is to ensure that financial institutions build up buffers during booms in order to run them down during downturns. Counter-cyclical regulation becomes an important tool for “leaning against the wind” by limiting credit creation and asset price bubbles.

This new regulatory philosophy, which has prompted initiatives in the U.S., Britain, and EU to establish new system-wide oversight and macroprudential policy arrangements, overturns the Greenspan doctrine that regulation is ineffective because regulators cannot adequately identify bubbles or keep up markets, and that regulation dulls market discipline by providing an illusion of safety. While the importance of macroprudential regulation is now widely recognized, considerable work needs to be done to reach agreement on how it might work and who should do the regulating. It also remains to be seen how well national risk regulators will work with supranational bodies such as the EU’s proposed systemic-risk council and the FSB. There are also countervailing worries that a systemic regulator would be biased either towards intervention, because it would face less criticism for puncturing a non-bubble than for failing to spot a real one, or towards non-intervention, because it would be subject to political pressure against tightening during a boom. In addition, there are concerns that the creation of an official systemic regulator could bring false comfort and thus engender excessive risk-taking.

Central bankers and regulators in the West have focused largely two areas of macroprudential regulation: (1) preventing the excessive build-up of leverage by strengthening and introducing a countercyclical element to capital standards; and (2) encouraging financial institutions to make provisions through the full economic cycle. But, with the exception of Switzerland, which introduced a new leverage ratio in December 2008, western central bankers and regulators have been slow to develop the necessary toolkit to implement these ideas.<sup>30</sup> A third area of macroprudential regulation that has received less attention in the West aims to encourage prudent lending standards and collateral policies. Here Asia has taken the lead in developing and deploying regulatory tools to help lean against asset-price movements.

Hong Kong, with its currency pegged to the dollar and therefore unable use monetary policy to restrain asset price bubbles, has instead relied on macroprudential regulatory tools. In the early 1990s it told banks to lend homebuyers no more than 70% of the value of a home, and to limit their exposure to the property market to 40%. In September 2009, Korea announced it was limiting the percentage of a borrower’s annual income that could be spent on mortgage payments to 50% in Seoul and 60% in two other areas with rising house prices. It has also put curbs on loan-to-value ratios. More recently, the governor of the Korean central bank indicated that price stability alone is no longer a sufficient target for central bank policy and that changes ahead will include expanding the central bank’s remit to include financial stability.<sup>31</sup>

In Singapore and China, policymakers are now trying something similar. In February 2010 the Singapore authorities barred lenders from making loans for more than 80% of the value of a home. It also imposed a stamp duty on all residential properties sold within a year of purchase. In April 2010 China’s cabinet, the State Council, said it would increase downpayment requirements on second and third homes, as well as for large first homes. It set a floor on mortgage rates and ordered cash-rich state-owned enterprises to stop moonlighting as property developers. Some luxury homes will also now be subject to property tax that previously excluded homes occupied by their owners. In addition, China’s banking regulator

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<sup>30</sup> The U.S. and Canada had leverage ratios in place prior to the crisis.

<sup>31</sup> Kim Choongsoo, Governor’s Bank of Korea 60<sup>th</sup> Anniversary Address (11 June 2010).

has plans to issue draft supervisory guidelines on a leverage ratio and countercyclical capital charges.

Asia's leadership in this area partly results from the fact that its model of capitalism is more conducive to regulatory intervention in the credit allocation process than the model practiced in the West. In the West central banks are comfortable with setting interest rates for the economy, but prefer to let the market decide who should lend how much to whom. In Asia, central banks are more comfortable with intervening in the credit-allocation process, arm-twisting banks, favoring some industries with credit and discriminating against others. Some in the West may now be following Asia's lead. For instance, in April 2010, Canada mandated that house buyers had to make a downpayment of at least 20% on investment properties they do not occupy themselves.

In July 2010, the BCBS released for consultation its initial proposals for countercyclical capital charges, which will be subject to considerable debate. Indeed, in the West important operational questions and considerations remain regarding the shift to macroprudential regulation. For instance, there is the issue of whether the deployment and calibration of macroprudential tools should be discretionary or subject to pre-determined rules. Regulators would also face the technical challenge of determining where they were in the cycle. They would also be subject to aforementioned countervailing pressures that could bias them for or against intervention. It would be politically difficult to take measures to reduce economic growth in the short term in the interests of fending off a bust that no one thinks will happen. On the other hand, regulators may lean toward premature intervention because of fears of criticism they would be subjected to for failing to spot a bubble. Both possibilities suggest the need for rule-based approach. But this would generate additional technical challenges, such as identifying the choice of index of systemic risk and the degree of pro-cyclicality that regulators wish to mitigate, as well as introduce additional complexity, not least because cross-border firms would be affected by many different cycles.

Rules are also subject to lobbying. Spain's central bank watered down its rules in 2004 because of lobbying, which argued the length of the cycle had made such rules redundant. The Spanish model, which is now held in high regard, is also not compliant with global accounting standards and did not prevent a bubble from developing. Still, Spain's banking system did emerge in better shape than most, though heading into the crisis its two largest banks had extra capital buffers that would have been insufficient to deal with the write-offs required for some of the worst performing banks such as UBS and Citigroup.<sup>32</sup>

Much of the focus of macroprudential regulation has been on developing ways to internalize externalities that arise from bank failures or contagion. This can be accomplished partly by reducing the probability and impact of failure by subjecting systemically important financial institutions (SIFIs) to higher capital charges. Countercyclical capital charges and dynamic provisioning can also help ensure that banks have more capital in reserve when bad times develop. Such measures have commanded broad support from the G-20 as have measures such as firm-specific contingency plans ("living wills") and special resolution regimes that could improve the process of winding-up institutions that have failed. A number of countries have introduced or have initiatives pending. The G-20 has also mandated that SIFIs identified by the FSB must develop internationally consistent contingency and resolution plans by the end of 2010.

In addition to these measures, the development of contingent capital, long-term debt instruments that convert to equity in times of distress, has also received much interest as way of boosting bank capital in bad times. Meanwhile, regulators have also started to develop crisis management groups and supervisory colleges for SIFIs aimed at facilitating

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<sup>32</sup> "Regulating Banks: Inadequate," *The Economist*, 12 March 2009.

information-sharing for assessing future failures, stress, and systemic risk. The G-20 has asked the FSB to recommend measures on the TBTF problems of SIFIs with a final report due in October 2010. While in broad agreement, the U.S. and EU have emphasized different aspects of the TBTF problem. The U.S., motivated by a desire to prevent future rescues and eliminate implicit state support for TBTF institutions, appears more concerned about setting up a regime that would clarify rights of different classes of creditors, while the EU, motivated by a desire to prevent future problems of winding-up cross-border firms such as those experienced in dealing with Lehman, Dexia, and Fortis, wants to ensure that cross-border claims are managed fairly.

Initially, these measures to deal with TBTF institutions suggested that officials had turned away from the more radical alternatives of placing limits on the size of banks or imposing a firewall between retail deposits and other liabilities of banks, thereby separating the utility elements of banking from casino-like activities and more speculative ventures such as proprietary trading. While size limits could prevent institutions from becoming TBTF, if a firewall was created between deposit-taking institutions and investment banks, as was the case in the U.S. before the repeal of the 1935 Glass-Steagall Act in 1999, only the former group would receive access to lender of last resort facilities and deposit insurance. The latter would see the implicit state subsidy for speculative trading removed and be subject to orderly resolution should they get in trouble.

In the U.S., advocates of this solution include Paul Volcker, former chair of the U.S. Federal Reserve and currently chair of the Obama administration's Economic Recovery Board, and in Britain, Mervyn King, governor of the Bank of England.<sup>33</sup> While during the election campaign both the Liberal Democrats and the Conservatives supported the full-scale break-up of big universal banks, once in office the coalition government in May 2010 instead agreed to establish an independent commission, which was given a year to investigate the issue. The delay has been driven largely by concerns about the lasting impact of unilateral action on the City of London's competitiveness as an international financial centre.

Indeed, for some time such measures seemed unlikely. Then, following an electoral defeat that caused his political party to lose its supermajority in the U.S. Senate, Obama proposed a series of markedly tougher regulatory measures. First, Obama proposed to enact a levy on any bank with a balance sheet over \$50 bn. The levy was intended to recoup some taxpayer money from the financial rescues, to encourage banks to shrink in size, and to clawback some of the implicit state subsidy enjoyed by SIFIs. In an effort to rein in excessive risk-taking and reliance on short-term debt and wholesale funding, the levy would tax bank liabilities minus deposits. Alongside the new levy came a new proposal for size limits on bank assets that would supplement an existing ceiling on deposits aimed at preventing investment-banking institutions from growing so large that they posed a risk to the system. The proceeds from the levy would be used to pre-finance a rescue fund for future bailouts.

Also included in the proposals was the so-called "Volcker Rule" that would prohibit commercial banks from engaging in proprietary trading or investing in hedge funds. The Volcker Rule, while stopping short of a forced separation between commercial and investment banks, would force banks to choose between owning an insured depository on one hand and owning proprietary trading operations or stakes in hedge funds and private equity firms on the other. They would, however, be able to continue proprietary trading related to their customers' businesses.

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<sup>33</sup> Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Washington, DC: Group of Thirty, 2009); Mervyn King, Speech at the Lord Mayor's Banquet for Banks and Merchants of the City of London at the Mansion House, London (17 June 2009).

Not surprisingly, private market actors responded negatively to the proposals, claiming it would prove hard to put an end to the kind of own-account activities Obama wants to stop without also impeding client-based investment banking he wants to continue. Yet while the banking community was universally opposed to the Volcker Rule, it remains divided on the levy. Some criticize it for being at best unnecessary given the drive under Basel III to raise capital requirements on the riskier activities of banks – such as proprietary trading – and at worst counterproductive as it would drain funds banks could otherwise devote to raising capital buffers. Others, such as Bob Diamond, president of Barclays, and Josef Ackermann, chief executive of Deutsche Bank and chairman of the Institute of International Finance (IIF), the global banking industry group – have backed the levy because it would secure greater stability and not change the competitive position of individual banks, although they suggested its universality raised the likelihood that the tax would be passed on to savers and borrowers.<sup>34</sup> Some central bankers and regulators sided with some in the banking community in opposing the levy, claiming that by institutionalizing the concept of TBTF the scheme would aggravate the underlying problem of moral hazard. It would also transform state funding of the banking system from an exceptional response in a dire emergency into an expectation, even an entitlement.

In light of these concerns and lobbying from banks, the legislation that emerged in the U.S. did not include the Obama levy and provided for a diluted form of the Volcker rule. At the time of writing, Obama's initial proposal for a levy, which aimed to raise \$90 billion over 10 years, is languishing in the Senate, though the House of Representatives did pass a version of it to fund a new orderly resolution mechanism. Initially, legislation agreed by Senate and the House did impose an upfront risk-adjusted levy on the nation's largest financial firms to raise up to \$19 billion to recoup the costs associated with the government seizing and winding down a failing firm after using its new resolution powers.<sup>35</sup> Banks with more than \$50 billion in assets and hedge funds with more than \$10 billion were to be required to pay into the standalone fund as a proportion of their assets. However, legislators scrapped the proposal days before the final vote on the legislation as they struggled secure sufficient to pass the financial regulation bill.

The Volcker rule was partly weakened to allow banks to invest up to three percent of their capital into in-house hedge funds and private equity, but the financial regulation legislation did impose a strict ban on banks trading on their own account. In practice, the new rule means many banks such as Goldman Sachs and Morgan Stanley will be forced to dismantle or shed proprietary trading desks and hedge funds, which have generated enormous profits in the past decade.

In Europe the initial reaction to the Volcker Rule was to offer no commitment to follow suit, preferring instead to rely upon the Basel III process. The French and German governments generally oppose any moves to split up their universal banks, arguing that their biggest banks survived the crisis relatively intact and that splitting them could lead to instability rather than a safer system. But officials within Europe were more divided on the question of whether to tax banks to pay for future financial rescues. Some, such as Juergen Stark of the ECB, worry about the moral hazard implications, while others, such as Mario Draghi, governor of the Bank of Italy and chairman of the FSB, and Philip Hildebrand, governor of the Swiss central bank, are supportive.

In April 2010, the IMF, to whom the G-20 had assigned the task of developing proposals to ensure the financial sector made a fair contribution to the cost of any rescues,

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<sup>34</sup> Patrick Jenkins and Tom Braithwaite, "Bankers in Favour of Paying Global Fee," *Financial Times*, 30 January 2010.

<sup>35</sup> Lawmakers had resolved to recoup the costs after any use of the so-called "resolution" powers but aides said that the vagaries of congressional budgeting meant there had to be an upfront fee of some sort.

came out in favor of national levies. Like the levy initially proposed by Obama, the Fund's report said that taxes should be placed on bank balance sheets, specifically their liabilities.<sup>36</sup> The IMF suggested the G20 nations start first with a flat tax on all institutions for simplicity, but that the rate could then be adjusted to reflect risk. The money raised could be sequestered in a special rescue fund or be added to each country's general revenue, the report said. If additional taxation is desired, the fund recommended a tax on profits above "normal" levels as well as high pay. To minimize moral hazard concerns, the Fund linked its proposal with the need to establish new resolution regimes.

But reactions to the widely-anticipated report have revealed sharp divisions among members of the G-20. Although the US, Britain, and European governments broadly agree on the need for a bank levy, it has been staunchly opposed by Canada, Japan, and Australia whose banks remained healthy during the crisis and do not want to see their banking systems unfairly penalized. India is also highly skeptical because it fears that taxes might threaten its efforts to boost financial inclusion. The Labour government in Britain, which had been lobbying other G-20 members for more than a year to adopt such levies, welcomed the proposal.

When the G-20 finance ministers met in April 2010 to discuss the report, disagreements among them led them merely ask for further study by the IMF. Then, in May 2010, the European Commission proposed an upfront levy on banks, with the proceeds to be paid into national funds to insure against future financial failures. The proposal, like the one in the U.S., has proven controversial, especially given worries about other countries not following suit. The Commission has stressed the proposal is not designed to bail out banks but to ensure that future failures and insolvencies are managed in an orderly way. The funds could be used, for example, to provide bridge financing, guarantees or for the temporary purchase of bad assets, a method used during the recent crisis. In spite of private sector opposition, the Commission has emphasized that banks should not be permitted to pass costs on to their customers. The intense debate that has followed has focused on the scale of the funds and whether levies should be imposed on bank assets, liabilities, or profits.

The Commission's proposal starts with a network of national funds, although it leaves open the possibility of creating EU integrated crisis management arrangements, and an EU resolution fund, in the longer term. Some European countries have already moved unilaterally to establish bank levies. Sweden, for instance, has already created a "bank stability" fund, financed by a small percentage fee levied on certain liabilities by banks and other institutions. Politicians in Austria, France, and Germany also have plans to impose a tax.

Public anger at past bank bail-outs remains strong and governments are so short of revenue that many bankers view some sort of tax as inevitable. But, as suggested, the industry itself is somewhat divided. The IIF supports taxing the industry to pay the residual costs of winding up failing banks but it argued in a report that an after-the-fact levy would be preferable. The problem with an up-front levy, according to the IIF, is that it engenders moral hazard. Yet other banking industry groups, such as the European Banking Federation and the British Bankers' Association, have indicated that their members have yet to establish a firm position on whether there should be resolution funds.

Some public officials share concerns about moral hazard. These concerns have led to the debate to focus on whether any bank levies should be dedicated to a specific purpose or available for use by national treasuries generally. The Commission's proposal, which has proven contentious, is for funds to be ring-fenced from national budgets. While some German politicians have come out in support of ring-fencing, moral hazard concerns have led

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<sup>36</sup> IMF, *A Fair and Substantial Contribution by the Financial Sector* (Washington, DC: IMF, 2010).

politicians in Britain and France to oppose the idea and instead support diverting funds to their general treasuries. German officials expect that the British and French position is based on their need to raise funds to help with fiscal consolidation. French officials argue that a standalone bank fund would raise complex management and design questions; would heighten the risk of moral hazard, with banks inclined to view this as an insurance policy; and, in any case, would not reflect the true value of the implicit guarantee to financial institutions provided by tax payers. Britain largely shares that position. The details of the Commission's proposal will be subject to intense negotiation and lobbying from the private sector. Technical challenges such as whether the levy would be on liabilities or profits, how such funds should be governed and who should trigger their use also must be addressed. The Commission expects to produce more detailed proposals in autumn, before coming forward with legislation early in 2011.

When the G-20 finance ministers reconvened in June, disagreements among the group led proposals for a global bank levy to be dropped, instead giving governments the leeway to pursue their own domestic agendas. For countries such as the U.S., Britain, France and Germany still wanting to go ahead with unilateral banking levies, the G-20 agreed that they should be devised within a set of principles to minimize the opportunities for banks to pick and choose between different jurisdictions depending on the levies introduced.

Several countries have since moved ahead, though with concerns about whether the U.S. will follow suit. The new coalition government in Britain has announced a new tax on banks. Although during the election campaign the Liberal Democrats and Conservatives took a forceful line on taxing banks, since taking office the coalition government has sought to balance concerns about the City of London's competitiveness with concerns about fairness to taxpayers. The new levy, announced in June 2010, will seek to raise more than £2 billion annually. The levy aims to rein in excessive risk-taking and reliance on short-term debt by taxing banks on the basis of total liabilities less high quality capital and insured deposits and by charging a lower rate of taxation on long-term debt. Funds raised by the levy will go into general Treasury coffers.

But in a nod to concerns that a unilateral levy would make the City of London uncompetitive, the Treasury stressed that both France and Germany had pledged to introduce a similar levy on their banks – though full details have not yet been provided (Germany intends to put a bank tax bill to its cabinet later in the summer, while France said it would present details of its levy in its 2011 budget, due to go to parliament in the autumn). Applying these levies to global banks will be complex. The tax will fall on branches of foreign banks as well as on their subsidiaries; but, since branches are underpinned by their parents' capital, this will have to rely on a calculation of notional capital.

Capital controls have also featured in discussions about macroprudential regulation, though initially their use was not framed in this manner. By limiting inflows and liquidity in the domestic financial sector, controls can help restrain excessive credit creation and asset price bubbles. Some have also argued that the revenue from an internationally coordinated tax on financial transactions, or "Tobin Tax," could be use to help recoup the cost of financial rescues.

In the early stages of the crisis a number of emerging markets, such as Argentina, Indonesia, Russia, and Ukraine, did impose controls on outflows as a way of managing contagion from the crisis. The IMF, which had become more accommodative of controls since the Asian financial crisis, endorsed their use as part of its programs with Iceland and Ukraine, but initially it did not encourage others to follow suit. Yet the leading advanced market economies in the G-20 did not waver in their commitment to the free flow of capital. To be sure, the crisis did heighten the traditional Franco-German skepticism of free market finance, but this skepticism did not yet spill over to the U.S. and Britain.

The political atmosphere began to change in autumn 2009. Monetary easing and liquidity support, while helping to save the financial system from collapse, permitted the financial sector to earn record or near-record profits and bonuses. This outraged the public at a time of rising budget deficits, public debt, and unemployment. Prominent politicians and regulators, such as the head of FSA and the then German finance minister, made statements in support of a global tax on financial transactions as one of several possible ways of recouping the cost of the financial rescues and as way to reduce the size of the financial sector and curb bonuses. But these statements did not command the support of the U.S. or UK Treasuries, though both did express interest in more work being done on how to discourage speculative behavior and on how banks could make a bigger contribution given their greater reliance on taxpayer support. It was then, at its September 2009 summit, the G-20 instructed the IMF to conduct the aforementioned report to examine how banks could contribute to the cost of the crisis, with the Tobin Tax being identified as one of several options under consideration.

In addition to the popular backlash that characterized the domestic political climate in advanced market economies, the broader intellectual climate began to shift. With the shattering of the pre-crisis intellectual consensus that identified markets as rational and efficient and that prioritized liberalization and deregulation, the stigma on controls, which identified them as market-unfriendly and imprudent policy, started to lift, and policies to cool down hot money became increasingly vogue and seen as a counter-cyclical macroprudential tool. It became increasingly accepted that capital controls could form part of the policy arsenal against future crises, especially the buildup of asset bubbles, by helping to counter-cyclically restrict credit growth and leverage. In October 2009, political momentum in support of controls increased when Brazil, flooded by liquidity unleashed by the extraordinary monetary easing in advanced market economies, imposed a tax on inflows to minimize pressures on the exchange rate to appreciate. Taiwan soon followed by imposing its own restrictions on overseas investors placing funds in time deposits. Since then other countries in East Asia, such as South Korea and Indonesia, have also imposed restrictions on capital inflows in order to protect their economies from financial instability and to reduce currency volatility.

In November 2009, then British Prime Minister Gordon Brown provided additional support for controls when shocked his G-20 colleagues by raising the possibility of a Tobin Tax as way that might help banks to pay for the insurance they received from taxpayers. Having spent more than a decade defending the City of London from heavy-handed regulation, the approaching British election and the public outrage on banker bonuses and the costs of the financial rescue led Brown to seek to cultivate a tougher image. Despite skepticism from the Bank of England, British officials then began to privately lobby the IMF to come out in favor of the Tobin Tax in its report. The US Treasury remained steadfastly opposed, while France welcomed the proposal.

In early 2010, the IMF added more legitimacy to the use of controls. Although it did not support the Tobin Tax in its report on how the financial sector could pay for the taxpayer support it receives, it did release another report that revealed greater support for capital controls than it has in the recent past.<sup>37</sup> The report identified controls as one of several legitimate tools that policymakers could deploy to moderate over-heating of their economies. Free-flowing capital can threaten emerging economies because surges of inflows can create shocks, causing currencies to rapidly appreciate and asset prices to soar, the Fund argued. There were thus important macroprudential considerations that supported the use of controls

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<sup>37</sup> Jonathan D. Ostry, Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reinhardt, *Capital Inflows: The Role of Controls*, IMF Staff Position Note SPN/10/04 (Washington, DC: IMF, 2009).

in some instances. By recognizing that in some instances sensible curbs on inflows might be a reasonable and pragmatic policy response, the Fund helped to lift the market-unfriendly stigma attached to controls.

In spite of opposition from the U.S. and doubts from the IMF, European leaders continue to press for consideration of a global tax on financial transactions as a way of dampening speculation and providing resources for future financial rescues. The recent crisis in Greece and across the eurozone has only served to heighten traditional European skepticism about speculation and free market finance. The new intellectual climate, continued popular outrage at excesses in the financial sector, and the Obama administrations newfound willingness to contemplate radical financial reforms promise to make the issue one of significant debate in the months to come.

Efforts to widen the regulatory perimeter have also featured prominently. Hedge funds, for instance, have come under closer scrutiny. As in the past, hedge funds have been accused in the crisis as having amplified downward pressure of asset prices through short selling. In the past when hedge funds had been put on the agenda they had been subject to a regime based on self-regulation and market discipline. This had largely reflected the preferences of the U.S. and Britain, where most of the hedge fund industry is based, and had run against the preferences of France and Germany who have had the long-standing objective of subjecting hedge funds to tighter regulation.

At the onset of the crisis, the regulatory response appeared to follow the same pattern. The first G-20 summit in November 2008 did not depart from the emphasis on self-regulation and market discipline. But by spring 2009 the situation had changed with the G-20 supporting bringing more of the hedge fund industry under purview of regulators. In the period between the November 2008 and April 2009 G20 summits, the position of the U.S. and Britain moved closer to that of Europe, indicating that they were prepared to impose bank-like prudential regulation on hedge funds of systemic importance as well as tougher disclosure requirements on all hedge funds. This permitted agreement to be reached on extending the regulatory net to some hedge funds. Still, the G-20 remains split, primarily between the U.S. and Britain, on the one hand, and France and Germany, on the other, over how aggressively to regulate hedge funds. France and Germany favor a tougher regulatory regime for all hedge funds, while U.S. and British officials continue to place the emphasis primarily on enhancing disclosure.

Three interconnected developments can account for this preference shift on the part of the US and Britain.<sup>38</sup> First, regulatory policy became increasingly politicized as a result of public outrage at taxpayer rescues of and excesses within the financial sector. With respect to hedge funds, public anger was directed at the steep decline and volatility in markets brought about by short-selling and unwinding of leverage. In the U.S., the Securities and Exchange Commission introduced temporary restrictions on short-selling, followed by many other securities regulators around the world, including Britain. Within the EU, politicization opened the door for French and German officials, as well as socialists in the European Parliament, to push for greater regulation.

The ideational orientation of U.S. and British politicians and regulators also shifted. The crisis had made these officials more skeptical of arguments stressing market rationality and efficiency and more receptive to activist government and direct regulation of the financial sector. Finally, the hedge fund industry itself became more supportive of regulation. In part, they could see the writing on the wall and in a defensive move sought to lock in the form of regulation they considered most acceptable. The endorsement of regulation also reflected a shift in the balance of power within the industry itself, with

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<sup>38</sup> Eric Helleiner and Stefano Pagliari, "The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance," in Eric Helleiner, Stefano Pagliari, and Hubert Zimmerman (eds.), *Global Finance In Crisis: The Politics of International Financial Regulatory Change* (London: Routledge, 2009), pp. 74-90.

investors demanding greater oversight of hedge fund managers as result of the industry's poor performance in 2008 and due to the scandal surrounding Bernard Madoff.

The content of the agreement reached among the G-20 has been closer to the national approaches developed in the U.S. and Britain than to the Franco-German proposals. With their expectations only partly met at the international level, Franco-German officials, and some of their allies in the European Parliament and European Commission, have pursued a much tougher approach at the regional level. Differences between the British and Franco-German positions currently feature prominently in the debate and negotiation over the proposed EU-wide directive aimed at regulating the hedge fund industry.

Amid public outrage against excesses in the financial system and the use of public money to rescue financial institutions, many G-20 countries made commitments to address remuneration in the financial sector, which many blamed for encouraging short-termism and excessive risk-taking. At first most countries were reluctant to delve deep into the details of compensation; instead preferring to issue broad principles and guidance that would be incorporated into supervisory reviews, though many did indicate that capital requirements could be raised on firms that failed to comply. Concerns that heavy-handed regulation could put their financial sector's at a competitive disadvantage led officials to shy away from prescriptive regulation. In fact, concerns about competitiveness led the FSA's initial draft code of conduct on remuneration, which included provisions that would force banks to defer bonus disbursements and include clawback provisions in case of negative long-term outcomes, to be later transformed from prescriptive regulation to a set of voluntary guidelines.

The FSF, for its part, developed a set of principles for compensation to ensure it was consistent with firms' long-term goals and prudent risk-taking.<sup>39</sup> Yet while identifying compensation schemes as one issue that merits scrutiny, the FSF stopped short of making a firm commitment on regulating them. At its April 2009 summit the G-20 endorsed these principles.

However, when public anger increased as news emerged of record or near-record bonuses in the financial sector, politicians sensed a target for increasing their stance with voters. In Britain, a Labour government facing the prospect of election defeat in a matter of months introduced a new "super tax" on bonuses. France soon followed suit and introduced tougher limits on pay that took the form of regulation rather than guidance. Other countries taking part in the G-20 summits, such as Australia, Britain, Germany, Italy, the Netherlands, and Switzerland, also rolled out new regulations. Remuneration subsequently emerged as one of the most divisive issues among G20 members at the September 2009 summit.

France raised objections to the use of guidelines rather than specific rules, a position which soon garnered support from Britain and Germany. The EU began to unite behind specific proposals to link the size of bonuses to fixed pay and to bank performance over long periods. Britain, France, and Germany came out in favor of binding rules that mandate deferring awards and clawbacks in case of negative outcomes. Yet differences remained within this group of countries as well as with the U.S. France and Germany proposed taxing or placing legal caps on bonuses, which the U.S. and Britain opposed. Still, concerns about public anger over bonuses and excessive risk-taking did prompt U.S. officials to support measures that sought to link pay to long-term performance. The U.S. gave particularly strong support for strengthening corporate governance through greater shareholder oversight of compensation.

In preparation for their September 2009 summit, the G-20 tasked the FSB with examining ways of limiting total variable compensation regarding risk and long-term

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<sup>39</sup> FSF, "Principles for Sound Compensation Practices," 2 April 2009.

performance as well as ways of addressing non-adherence to FSB principles. At their summit the G-20 endorsed the FSB report that called for bonuses to be linked to the long-term success of financial companies and not excessive risk taking. The report also urged avoiding multi-year guaranteed bonuses, called for a significant proportion of bonus payments to be deferred and for the development of mechanisms for clawing back bonuses paid if a company subsequently performs poorly. The FSB guidelines also for the first time specified the proportion of bankers' bonuses that should be paid in the form of deferred compensation. However, the report stopped short of recommending a formal cap on pay; instead proposing that firms limit bonuses when it is inconsistent with a bank's sound capital base.

G-20 members have begun to implement these principles at the national level as well as at the regional level in the case of the EU. Interestingly, the first ever FSB peer review of its member compliance with new financial regulatory principles was conducted in the area of remuneration, with a report issued in March 2010.<sup>40</sup> Not surprisingly, the report found greater harmonization in areas where G-20 members agreed – strengthening corporate governance, establishing supervisory oversight and promoting disclosure – and less in areas where their positions clashed, notably risk-adjustment of compensation. For instance, in the case of deferrals, while Brazil, China, France, Germany, and the UK regulations include specific minimum expectations for amounts to be deferred, the U.S. guidance suggests “substantial” deferral for an “appropriate” or “extended” time period. France and Germany have also introduced specific ratios that indicate the proportion of variable compensation that must be awarded in shares or share-linked instruments. Most other G-20 members have not. In addition, under legislation that passed the European parliament in early July 2010, similar ratios will be applied across the EU. The FSB report also revealed a split between European and North American regulators, who have implemented measures to regulate pay, and group of emerging markets moving far more slowly. The split underscores the importance of compensation to reforming the financial system between these two groups of G-20 members. Banker pay has been a major political issue in Europe and the U.S., while Asian and Latin American countries have tended to view pay as a secondary problem.

Going forward the BCBS has initiated work to develop by end-October 2010 a consultative report on the range of methodologies for risk and performance alignment of compensation schemes. Initiatives are also underway in other bodies, such as the EU and the International Association of Insurance Supervisors (IAIS), for extending the coverage of standards and guidance on remuneration to nonbank financial institutions. The FSB plans to conduct another review of practices in 2011.

Regulation to be taken in other areas has commanded greater consensus. The initial reports from the FSF urged strengthening of the oversight of CRAs and their methodologies. CRAs occupy a central position not only in the securitization process but also in the risk-weighting process in Basel II, the collateral regimes of many central banks, as well as in the rules of many securities regulators. CRAs provide a rating that enable securities to be sold, minimum capital requirements to be assigned, liquidity support from central banks to be accessed, and various disclosure and investment requirements to be met. When the housing bubble burst, it became clear that CRAs had seriously underestimated the risk attached to ABS. In the more recent debt crisis in the eurozone, CRA downgrades have been blamed for amplifying market turmoil.

Critics attribute the failures of CRAs to three conflicts of interest inherent in the business models of CRAs. First, CRAs use an issuer-pays business model that means they

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<sup>40</sup> FSB, “Thematic Review on Compensation,” 30 March 2010.

are paid by the issuers of the securities rather than investors. This permitted investment banks to “ratings shop.” Second, CRAs based their ratings on information provided by issuers, which raised problems of data quality and undermined incentives for due diligence. Third, CRAs acted as advisers on how to structure securities so that they achieved the best rating, and then rated the same securities.

The most important international attempt to reform CRAs has been led by the International Organization of Securities Commissions (IOSCO), which has revised its code of conduct for CRAs to improve practices and procedures for managing conflicts of interest, assure the transparency and quality of the rating process, and develop a new methodology for structured credit products. This initiative was endorsed by the FSF in its early reports on the crisis.

However, the IOSCO initiatives have been viewed skeptically in some policymaking circles, particularly in the EU, who have called for more radical changes. Many in Europe were particularly dissatisfied that the IOSCO initiative left the self-regulatory regime for CRAs largely intact. EU governments subsequently reached agreement on region-wide rules for CRAs, requiring registration with a pan-European body, conditional on meeting several requirements such as greater transparency, a new methodology for structured credit products, and avoidance of conflicts of interest. Australia, Canada, Japan, and Korea later introduced similar requirements.

The U.S. Securities and Exchange Commission (SEC) introduced a series of measures to improve accountability, including the creation of a new group of examiners to oversee CRAs. The SEC sought to tackle conflicts of interests by introducing new rules prohibiting CRAs from providing both ratings and advice on how to structure securities. New SEC rules also require greater transparency, mandating that CRAs reveal more information on past ratings, fees, and methodologies. The new SEC rules also grant CRAs access to data that would permit them to offer unsolicited ratings for structured credit products and require among other things additional disclosure about whether there was “ratings shopping.” The G-20 gave broad support to such measures and called for steps to be taken to avoid conflicts of interest, provide greater disclosure, and introduce new ratings for structured credit products.

The G-20 also agreed to review the use of ratings for regulatory and supervisory purposes. The BCBS is currently working to address the use of CRAs in the regulatory capital framework. The SEC has moved to remove certain references to CRAs in its rules. The Bank of England, following the ECB, has indicated it will undertake its own risk assessments in the future for many classes of assets accepted as collateral.

In early 2010, pressure to tighten regulation of CRAs increased in light of criticism of the eurozone debt crisis and a U.S. Senate investigation that uncovered new evidence that two top CRAs were unduly influenced by investment banks and willfully ignored signs of fraud in the lending industry. In Europe, the Commission began to seriously explore the possibility of setting up a European CRA that could break the oligopoly of the American firms that currently dominate the market. Following the SEC’s earlier measures, the Commission also moved to increase competition by proposing that information on which ratings are based is accessible to all rating firms. In the U.S., the Senate approved an amendment to its version of the financial regulation bill that contains a provision to establish a government-appointed panel to decide who rates an individual ABS – a serious threat to the CRA business model. Under the new credit rating agency plan, a board set up by the SEC would decide which agencies get which business to eliminate ratings shopping and potentially allow new entrants to capture market share. Yet during the conference session to reconcile the House and Senate bills, legislators agreed to delay implementation of this proposal; instead putting it out to a study, opening the possibility that it could be weakened or dropped.

On the issue of regulating derivatives, the G-20 has reached a broad consensus. The FSF encouraged market participants to develop a more robust infrastructure and clearing system for OTC derivatives. The organization representing this sector, the International Swaps and Derivatives Association (ISDA), as well as various futures exchanges, hedge funds, and banks have since moved forward in working with U.S. and European regulators to develop such an infrastructure. The G-20 declarations have made it a high priority for regulators to speed efforts to improve the resiliency and infrastructure of the OTC derivative market in general and the CDS market in particular. Standardized OTC derivatives are to be traded on exchanges or electronic trading platforms and cleared by central counterparties by end-2012. Non-centrally cleared contracts are to be subject to higher capital requirements with the FSB assessing implementation of these principles.

While the U.S. and EU have moved largely in the same direction, one issue of debate concerns whether there should be exchanges in several countries or only a few – or even one – to ensure data is not fragmented across jurisdictions, making it harder to regulators to have a unified view of trading. European officials are keen to have at least exchange in the EU to ensure they have easy access to data and are not left out. There is also a concern in Asia that the region does not get left behind in the race to reform the vast OTC market. Japan, India, China, Hong Kong, Singapore, Korea and Taiwan have all created task forces to study setting up clearing operations for the opaque OTC markets, either by using existing clearing houses or by setting up clearers specifically for OTC derivatives.

Another issue concerns harmonizing across countries which OTC derivatives will be subject to mandatory clearing and trading on exchange. In both the U.S. and EU, banks, which stand to lose significant profits, and non-financial end users of derivatives, who would face stricter margining and capital charges, have lobbied hard for exemptions to mandatory clearing and exchange trading. Opponents claim exemptions will act as loopholes. The U.S. financial reform legislation provides for some exemptions, while the European Commission has signaled that in principle non-financial end users could be exempt from clearing. In Britain, the Treasury and FSA have cautioned against too much clearing given the systemic risks that could build up in clearing houses and the serious consequences that would result from default. Concerns are also building about the possibility of regulatory arbitrage should policymakers fail to converge on a consistent global approach.

While substantial, the pace of reform in derivatives markets in the US and EU has been much slower and less heavy-handed than that implemented in China, where regulators moved in 2009 to shut down the main route by which foreign banks sold derivatives from offshore operations and banished speculative deals. The moves came after deals with western banks to hedge against commodity price, interest rate, and currency swings led to massive losses for Chinese firms. Regulators suspected that in some instances firms used derivatives to speculate, rather than hedge, while banks frequently sold overly complex products – the most profitable – without fully explaining the potential downside.

China later postponed a plan to introduce CDS to its domestic market after regulators objected and senior officials vetoed the proposal following discussion over the derivatives' contribution to the global financial crisis. The plan to launch a CDS pilot project in China was advanced and enjoyed preliminary support from the central bank. But other regulatory bodies, including the banking watchdog, were opposed at a time when governments are attempting to rein in the market for complex credit derivatives.

As the eurozone reeled in turmoil, the approach of some leading countries began to mimic that practiced in China and elsewhere in Asia. Sovereign CDS became a new villain in Europe, with French and German politicians blaming hedge funds for driving up the price of insuring against a Greek default and exacerbating the financial crisis in Athens by panicking investors. As a result, the Commission brought forward to this autumn measures to

tackle speculative trading, notably in relation to sovereign CDS. Then, in May 2010, Germany moved unilaterally to ban naked short-selling of eurozone sovereign bonds and CDS as well as the shares of some leading German financial stocks. The Dutch government soon came under pressure to follow suit, following a parliamentary vote calling for similar restrictions in the Netherlands. Under pressure from Germany and France, the European Commission has recently mooted giving European regulators powers to ban or restrict trading in CDSs if these related to the potential default by a member country.

Domestic political considerations weighed heavily on the German decision, with the government seeking to boost support in parliament and among the electorate for the country's share of a new eurozone rescue fund developed in response to the Greek crisis. Electoral considerations also prompted some in the US to take a harder line on derivative regulation, with one provision in the U.S. financial regulation legislation requiring banks to spin off their riskiest derivatives trading operations into separately capitalized affiliates. The influential sponsor of the provision introduced it largely to appeal to anti-Wall Street voter sentiment ahead of a closely fought primary election. Still CDS are not without influential backs; the IMF has concluded that naked shorting of CDS was a legitimate risk management tool, while studies by regulators including the FSA and the German financial regulator have found no evidence that CDS trades have affected the bond market.

### **Conclusion: Political Economy Perspectives on International Financial Regulation**

What accounts for this extraordinary array of international regulatory initiatives? Political economists typically focus on three broad factors. These factors are often complementary in nature, though they can push governments in opposing directions.

State power and interests is one important factor.<sup>41</sup> The power and interests of leading states in particular is often a key determinant of the content and scope of regulation. Leading states will broaden, shrink, or veto international regulatory initiatives depending on how they stand to benefit or lose. Leading states will often use international coordination to level the playing field and avoid the competitive consequences of unilateral regulation, as well as lock in their preferred regulatory solution at the international level.

Power in international financial regulation comes from many sources. States can derive power from the importance of their financial markets, firms, and currencies. Leading states can use the threat of denying access to their markets or domestic regulatory changes to prompt responses elsewhere. Leading states may also enjoy a form of "soft power" that comes from the status of being regulators of leading markets, a status that gives them prestige as a model to be emulated. Leading states may also possess significant influence over international institutions and standard-setting bodies. Pressures for convergence will typically arise when divergence produce negative externalities for leading states.

In spite of the damage the crisis inflicted on their financial markets, firms, currencies, and prestige, the U.S. and Britain both remain important powers driving international regulatory change. In some areas, such as remuneration, the U.S. and Britain have been able to narrow or veto more ambitious regulatory initiatives. In other areas, such as hedge funds, changes to U.S. and British preferences, which removed their earlier veto, were critical in ensuring tighter regulation. In Britain, concerns about the competitive impact of unilaterally imposing a levy on banks led the new coalition government to delay implementation and seek to reach a global accord to level the playing field.

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<sup>41</sup> Daniel Drezner, *All Politics is Global: Explaining International Regulatory Regimes* (Princeton: Princeton University Press, 2007); Beth A. Simmons, "The International Politics of Harmonization: The Case of Capital Market Regulation," *International Organization*, 55 (3):589-620.

The EU has also shown itself to be able to exercise greater influence. The emergence of the euro as an international currency, regulatory harmonization and financial market size has helped the EU become a more important player in international regulatory debates. The EU's current efforts to influence the IASB are perhaps the most obvious example of its growing capacity to shape international financial regulation. However, the above discussion also clearly revealed that the EU's ability to exercise leadership has been and likely will continue to be constrained by different regulatory philosophies that exist between key member states, notably between Britain on the one hand, and France and Germany on the other.

East Asia has also shown that it too is an emerging power in international regulatory politics. The transfer of wealth toward East Asia in the last decade has given the region both more global financial clout as well as the ability to chart a more independent course. The current crisis has reinforced this power shift by undermining the dominance of U.S. and British financial firms and markets as well as damaging the soft power that originated from the reputation of New York and London as leading financial centers. The Asian financial crisis led many policymakers in the region to gain interest in Anglo-American regulatory models.

The current crisis, as illustrated by China's recent decision to suspend a pilot program for a CDS market, may be having the opposite effect and it may even stir others to emulate the more cautious approach to financial regulation adopted by some countries in the region. Leading East Asian powers have been brought for the first time into the leading international regulatory forums, but with the exception of the deployment of macroprudential tools, they have yet to take on a strong leadership role in this area. In fact, while critical of the self-regulation and those parts of the Basel II regime associated with it, the views of many Asian officials have been largely in line with those criticisms offered by officials in the U.S., Britain, and Europe. China, for instance, intends to complete implementation of Basel II by the end of 2010. Indonesia is also currently implementing Basel II. The hesitation of officials in China and elsewhere in Asia to break from the BCBS-centered standards reflects in part the use of such standards by reformers to promote financial sector reform, as well as much lower levels of domestic politicization pressures of the kind that resulted from countries with taxpayer financed rescues of failed banks.

Still, there are some signs that some in the region to take a much stronger revisionist stance. For instance, the so-called BRIC countries – Brazil, Russia, India, and China - have signaled their growing political resolve to shape economic affairs by issuing their first joint communiqué in February 2009, which has been followed by additional statements in later summits. China has also become increasingly outspoken in area of international monetary reform by floating proposals that would replace the current dollar standard with an SDR standard.

Domestic politics is another important factor that often features in political economy analysis.<sup>42</sup> The complexity of the issues involved, their more indirect and less obvious distributional consequences, and an often insulated policymaking context mean that debates over international financial regulation are typically confined to a narrow range of actors. The most active and consistent participant are private market actors for whom the distributional costs are more immediate. Private market actors also may have concerns about adjustment costs to new regulation or may see international coordination as a way to gain

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<sup>42</sup> Thomas Oatley and Robert Nabors, "Redistributive Cooperation, Market Failure, Wealth Transfers and the Basle Accord," *International Organization*, 52 (1):35-54; David A. Singer, *Regulating Capital: Setting Standards for the International Financial System* (Ithaca, NY: Cornell University Press, 2007); Daniel Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Washington, DC: Peterson Institute for International Economics, 2008).

market share. Private market actors typically oppose intrusive regulation and support market-drive solutions. For these reasons the light touch regulatory trend in the pre-crisis period is often seen as an example of “regulatory capture.” The influence of the financial sector is based on the resources it can mobilize for lobbying and campaign finance contributions as well as its control of technical expertise and the prestige that comes from its enormous profitability. “Revolving doors” between the private financial sector and public office also ensure that interests of financial market participants receive attention.

Yet the exception to this general pattern of societal involvement occurs during, and in the wake of financial crises when financial regulation becomes more politicized in wider society. Large-scale use of taxpayers’ money heightened politicization to an unprecedented level, unleashing popular pressures in favor of stronger regulation, particularly in the U.S. Congress and European Parliament. Evidence of misconduct and malfeasance, such as that uncovered in the CRAs as well as allegations of fraud brought against Goldman Sachs in spring 2010, have also intensified politicization. Remuneration in the financial sector, bank levies, and the introduction of the Volcker Rule are a few initiatives that vividly illustrate the impact that such politicization can have on regulation. Interestingly, the severity of the crisis also generated support for new regulation from among private market actors, though primarily for defensive reasons.

Political economy analysis also typically points to the importance of ideas.<sup>43</sup> Ideas help to inform the way public officials understand how the economy works, the key economic issues they face, and the appropriate policy templates to remedy these issues. The content and scope of regulation policy templates will often stem from a particular set of ideas. Ideas will become particularly influential when they have hardened into an orthodoxy or ideology. Certain forms of regulation may become delegitimized or unthinkable within a particular climate of opinion. Regulators may develop blind spots as a result of particular orthodoxies. International coordination becomes more likely when actors converge on a common set of ideas or “focal point.” Yet when the legitimacy of a particular set of dominant ideas is called into question, international coordination can become more challenging as actors grapple with competing diagnoses and policy templates.

One more important ideational shift has been the elevation of fairness to an equal status as competitiveness in the value hierarchy of international finance. In Britain, for instance, the pre-crisis consensus rested on the need for light touch regulation to support the City’s international competitiveness. Little concern was paid to how the enormous returns this generated the City of London contributed to rising inequality. Yet taxpayer-backed financial rescues have prioritized the importance of fairness and generated initiatives such as the introduction of bank levies and demands and measures to induce restraints on pay and bonuses. With high levels of unemployment, stagnant wages, and slow growth in advanced market economies, the corollary of rising profits in 2009 for the financial sector has been a fall in the share of income going to labor.

For many voters this seems unfair: the financial sector that caused the crisis and was then rescued by taxpayers is now reaping a disproportionate share of the rewards from government stimulus efforts. Meanwhile, rising debt burdens and gaping budget deficits, in many cases brought on by efforts to rescue the economy from collapse, are leading governments to impose deep cuts in public services and public-sector pensions and wages – seemingly at the insistence of the financial sector. It is thus no small wonder that many governments in rolling out their austerity plans have sought to extract a sizeable contribution

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<sup>43</sup> Mark Blyth, “The Political Power of Financial Ideas: Transparency, Risk, and Distribution in Global Finance,” in Jonathan Kirshner (ed.), *Monetary Orders: Ambiguous Economics, Ubiquitous Politics* (Ithaca, NY: Cornell University Press, 2003), pp. 239-259; Jeffrey M. Chwieroth, “Neoliberal Economists and Capital Account Liberalization in Emerging Markets,” *International Organization*, 61 (2):443-463.

from the financial sector in the name of fairness. A failure to do so would likely generate sizeable political unrest.

In terms of international cooperation, the pre-crisis orthodoxy clearly shaped the content and scope of international financial regulatory initiatives, ensuring the dominance of the Anglo-American light touch regulatory model, at least in key international financial forums. Yet the pre-crisis orthodoxy also created significant blind spots, notably in the area of macroprudential regulation. The crisis has clearly called the pre-crisis orthodoxy into question. This has permitted a range of new initiatives reflecting a diversity of regulatory views to emerge. In some areas, such as hedge funds and OTC derivatives, the discrediting of the pre-crisis orthodoxy has enabled governments to reach broad agreement on tightening regulation in areas where such action had been previously vetoed. The discrediting of the pre-crisis orthodoxy has also helped breakdown stigmas associated with some policy tools such as capital controls. Yet even in areas where politicians and regulators have reached some kind of new consensus, such as the need for macroprudential regulation, there remain serious disagreements about the operational details.

A more serious ideational obstacle to international regulatory cooperation comes from differing views among G-20 members as to how to evaluate the trade-off between growth and stability. While the self-regulatory norm of the Anglo-American model has been discredited, the model continues to be associated with greater innovativeness, dynamism, and faster growth, which attracts much interest. On the other hand, China's capacity to avoid the worst effects of the crisis has led many to gain interest in its more cautious, highly regulated model, which, while producing a relatively unsophisticated financial sector, has produced greater stability. The EU, Japan and other countries in Asia have also sought to project models based on more highly regulated financial systems.

The trade-off between faster growth and greater stability promises to feature prominently in debates to redesign the contours of international financial regulation. The more highly regulated model, while less likely to trigger large fluctuations in financial stability and macroeconomic activity, may produce slower economic growth. On the other hand, regulatory models that permit more financial innovation, higher leverage and the greater ability to take on risk may be associated with more rapid economic growth, though at the cost of greater financial instability. How governments evaluate this trade-off at the national level will depend largely on domestic social and normative priorities. International regulatory coordination then becomes a game not only of seeking to lock in one's domestic approach internationally to avoid the material costs of an unlevel playing field but also of projecting one's domestic approach as the model to be emulated internationally so as to avoid the normative and social costs of adjusting one's approach to the priorities of others.

At this point we are, as Helleiner suggests, in a kind of interregnum where the old orthodoxy has been discredited but a new orthodoxy has yet to be consolidated. In other words, there is currently no clear focal point for international cooperation. Much of the debate among the G-20 has reflected US, British, and European efforts to project their domestic social and normative priorities internationally, and to accommodate the growing power and clout of China and others in the region. Given the divergent social and normative priorities of these actors, and as well as of those emerging markets recently included as new members in key international forums, it is possible that the interregnum could be prolonged and that the global financial system evolves into a more decentralized and fragmented order. If reforms to international financial regulation fail to meet the expectations of leading players, then, as Helleiner suggests we are likely to see "centrifugal tendencies" grow in intensity. The US, Britain, Europe, and Asia could chart an increasingly independent course that diverges from the G20-led reform agenda, by eschewing universalist standards and codes in favor of alternative national and regionally defined forms of financial governance. Indeed,

we are already witnessing growing unilateralism in the form of disputes over bank levies, the Volcker Rule, and bans on naked short-selling. At the moment, power considerations, domestic politics, and ideas appear to be pushing countries away from multilateralism and toward more national and regional responses. Indeed, looking back, the April 2009 summit may have been the high point in international coordination.