WHO RULES THE FINANCIAL SYSTEM?

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Who rules the financial system?

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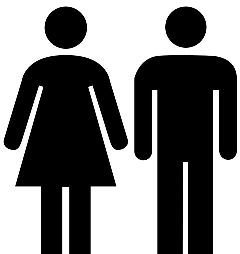
: Summary



: Presentation

It is now conventional wisdom that the room for democratic processes has been dramatically curtailed by the process of financial liberalization begun in the 1980s, domestic as well as international. This happened in rich countries, and even more intensely in developing countries. Financial investors have replaced citizens in a power system in which the "markets" (meaning by that *financial markets*) increasingly subtract power from the people.

If national states are weakened in this process by the growing dominance of financial markets, new layers of power have been created at the international level. The history of modern capitalism shows that, in the absence of regulation and supervision, financial markets tend to create risks that periodically surface in the form of destructive crises, such as the 1997-1998 asian crisis, the 1998 russian crisis, and the 2001-2002 argentine crisis. Therefore, the recent rapid growth and globalization of financial markets stimulated the creation of operational and prudential rules expected to limit the potential damages this process may ultimately cause. Everyone everywhere should be interested in these initiatives, particularly because, with financial markets made increasingly interdependent by globalization, everybody can be hit by a financial crisis, as was clearly the case with the 1998 russian crisis and its sequels.

The institutions where these debates take place, however, are not open to the participation of all interested parties, to say the least. Some of them, such as the Basle Committee for Banking Supervision, have their membership restricted to the richest of the rich countries. Developing countries, civil society organizations, and professional associations can be heard, by invitation only, but have no means to really influence the outcome of the debates. Other institutions, such as the International Monetary Fund are more open to wider participation. However, decision powers are distributed in extremely inequitable ways, making the less developed world at best a set of supporting actors. In other words, there is a dramatic *democratic deficit* in these institutions' operations. Nevertheless they don't shy away from making decisions that have a profound impact on the life and welfare of the excluded societies.

The goals of the *Financial Liberalization and Global Governance: The Role of International Institutions* project, coordinated by Ibase, gathering the efforts of activists and specialists from 12 countries, under the sponsorship of the Ford Foundation, are precisely to investigate the *democratic deficit* in the debate and decision processes embedded in those institutions, and to propose ways to overcome this deficit. It is not primarily, or even mainly, an academic project, but is instead a *political* initiative. It aims at contributing to strengthen the hand of social movements and organizations, developing country governments, members of parliaments, among others, in their everyday struggle to demand voice and influence in the institutions that conceal their power in the informality of their bylaws or on the biases of their rules of engagement.

This pamphlet constitutes a first result of the project. It addresses the democratic deficit within the international institutions that formulate financial regulation strategies, and shows the importance and the results of these institutions' current modes of functioning. The text is based on the works and debates produced during the first stage of the project – begun in July 2006 and just finalized. The next stage is expected to be completed by 2009.

In the first stage, the project paid special attention to institutions such as the Basle Committee and to the difficulties faced by civil society organizations, academics and government officials in their attempts to establish a dialogue with them. The project will move forward on two fronts. On one hand, it will explore the possibilities for increasing the accountability of international institutions; on the other hand, it will explore proposals that should be considered by these regulatory institutions so as to take into account the interests of the peoples in developing countries as well as the interests of those social segments in rich countries that are also powerless in this arena.

This pamphlet was written by the coordinators of the project, Fernando Cardim de Carvalho and Jan Kregel, and is largely based on the contributions of the project's other participants. However, the responsibility for this publication rests entirely with the coordinators. The papers produced by the project's other participants are available at the Ibase's website <www.ibase.br>.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Introduction: neo-liberalism and financial liberalization

The recent implementation of neo-liberal policies has been responsible for the weakening, or actual elimination of, social reforms that had been implemented around the world in response to the 1930s depression. It has promoted deregulation in many areas, from the protection of the environment to the protection of consumers. Under the pretext of freeing private entrepreneurs from the burden of state interference in economic affairs, taxes have been reduced, exclusively to the benefit of the rich; labor rights have been threatened or actually curtailed, and social benefits for the poor have been reduced. In the international arena, the focus on development programs was replaced by pressures for trade liberalization and for the adoption of the so-called "market-friendly" "structural adjustment" policies that have spread crises and stagnation across the developing world. Aid for the poorest countries has been reduced, and what remains has been made subject to conditionalities that prevent developing countries from dealing not only with their poverty, but also with urgent problems such as health and education. The hardships brought about by neo-liberal policies are multiple. A century of slow and hard-won social achievement and solidarity is under threat by the continued dominance of neo-liberal ideology.

It has been widely known that financial liberalization constitutes one of the main pillars of neo-liberal doctrine. It may in fact be the main policy instrument of the neo-liberal counterrevolution, since it dramatically circumscribes the power of the state to promote progressive social reforms. Nevertheless, the actual workings of financial markets and the reasons why financial liberalization is so important are usually shrouded in obscurity. Ordinary citizens, as well as political parties, civil society organizations, and activists are frequently led to believe that knowledge of how financial systems work is accessible only to technically trained financial investors and a few expert economists. Even progressive politicians and civil society activists, accustomed to harsh political battles, are intimidated by the arcane language employed by defenders of neo-liberal policies. As a consequence, the most general and visible achievement of neo-liberalism has been the ease with which financial investors and their spokespeople in the economics profession have been able to deflect any criticism of the policies they sponsor. Progressive politics has been restricted to the area of *social* policies that are designed to attenuate the cost to the population at the expense of eliminating those policies that provided social protection and advancement in the past. The great victory of neo-liberalism was to convince progressive movements that economic policies are the *exclusive* sphere of professional economists, particularly those working for financial institutions and voicing their interests and demands.

Consequently, one of the most important *political* demands of our time is to remove the veil that covers the workings of financial markets and institutions in order to make it accessible to ordinary citizens and civil society activists. There is absolutely nothing *relevant* about financial systems that cannot be understood and evaluated by suitably informed common citizens.

In this brochure, a central set of questions will be explored. How did financial markets come to be so powerful? Why do government leaders, even those freely elected at the head of progressive movements that promise fundamental social changes, feel so intimidated that they see no alternative but to sacrifice their promises to the demands of banks and financial investors? How are international governance rules established in a context in which governments don't feel empowered to control even their own domestic situation?

Financial liberalization and the power of the State

Financial liberalization is actually a two-pronged process that runs through parallel, but to some extent independent, lines. *Domestic* financial liberalization is focused on the deregulation of national financial markets and on the consequent change of economic policy instruments to adapt to the new rules. *International* financial liberalization, on the other hand, has consisted in dismantling capital controls so as to increase the freedom with which financial capital can move across national boundaries. Thus, domestic financial liberalization has operated through a change in domestic rulebooks that set norms for the operation of national financial institutions and markets. International financial liberalization has taken place through the liberalization of the capital account of each country's balance of payments.

Domestic financial liberalization

For most of the twentieth century, domestic financial transactions in practically every capitalist economy were strictly regulated. Interest rate ceilings, rules for prudent operation of banks and other financial institutions, limits to the kinds of businesses that could be explored by each class of financial institution, norms to protect investors from market manipulation by financial agents were common features of any capitalist economy, even in those countries accepting more liberal political views, as the United States and Germany.

BALANCE OF PAYMENTS

A country's balance of payments is a national account that represents the transactions of a given economy's residents with foreign counterparts during a given period of time. Individuals and organizations (including governments) that maintain a resident status or are headquartered in the country will require foreign currency to undertake two types of transactions: buying goods and services and buying financial assets. They acquire foreign exchange through transactions that sell goods and services to non-residents or that sell domestic financial assets. The transactions in goods and services are recorded under the title Current Account, those in financial assets in the Capital Account. Thus, the current account includes exports and imports of goods and services, incomes (such as profits, interest payments, etc), and unilateral transfers (like gifts, giving or receiving foreign aid, expatriate workers' remittances, etc). The financial and capital account records the flows of direct investments, portfolio investments, and international operations with derivatives and other investments, including bank loans and compensatory loans, such as those made by the IMF to overcome exchange crises.

When a country's residents sell more goods and services and financial assets to non-residents than they acquire, there is a net surplus of foreign currency in which is called International Reserves (conversely, when expenditures are greater that revenues, these reserves are reduced).

In common usage, the expression "balance of payments" came to refer to foreign transactions in general, not only to the accounting document as such. Thus, it became common to refer to a *balance of payments crisis* when a country's reserves are depleted and there are expenses that still remain to be liquidated.

The language of the balance of payments is also used in another context. During the Bretton Woods conference, in 1944, it was agreed that the participating countries would accept settlement in the buyer's currency of any international trade contract that conformed to accepted legal standards. Thus, no country could prevent a legitimate commercial operation from being completed by withholding foreign currency. This was called *current account convertibility*. Similarly, in 1997, the IMF proposed an amendment to its Articles of Agreement that would eliminate the existing right of individual countries to impose capital controls. In the IMF language, this would have meant extending current account convertibility to *capital account convertibility*.

The reasons for the implementation of extensive regulation and permanent supervision of financial markets and institutions were rooted in the perception that while well-operating financial systems can be powerful instruments to promote capital accumulation and economic growth, they can also constitute an enormous threat if allowed unfettered operation. This was not an *a priori*, theoretical expectation. On the contrary, these fears sprang from actual experiences with financial crises in the 1920s and 1930s.

No financial crisis was so important in shaping political attitudes with respect to financial systems as the 1930s depression. This episode in fact exhibited the whole range of evils that one could expect from a financial system run amok: intense stock market speculation, involving ever-increasing shares of an ill-informed and easily manipulated population, ending in a spectacular crash in 1929; the action of financial conglomerates that tried to cover their losses in the stock markets by diverting resources directed to credit markets; loss of deposits resulting from the spreading perception that banks were exceedingly fragile; attempts by banks to keep clients by offering rising (but unpayable) interest rates; and, finally, the collapse of the financial system that initiated the depression proper.

The reaction was swift and harsh, particularly in the United States. Tough measures were adopted to restrain the freedom of operation of financial institutions and markets, particularly in the banking sector. Ceilings were imposed on interest rates paid on deposits. Blatant forms of market manipulation were outlawed and watchdog institutions were created to monitor markets. Finally, safety nets were created to attenuate the worst effects of financial crises in case they took place again, despite all the precautions taken.

If developed countries felt the need to regulate financial markets more or less strictly, this was imperative for developing countries. In these nations, private financial markets are small and ill prepared to give the support to productive activities and investment that the financial systems have in developed countries. Resources tended to be much more costly – so much so that most of the time, productive investments were priced out of the markets. In most of these cases, regulation to prevent crises was certainly not enough. Financial systems were not efficient even in the best of times and more active intervention by the state was a fundamental necessity. This intervention took three main forms: the imposition of limits on interest rates, the demand that private financial institutions direct a share of their investments to socially beneficial activities, and the creation of public financial institutions to offer development finance. One should notice that many of these same instruments were also used in developed countries during period of reconstruction after World War II.

Beginning in the 1970s a wave of financial market deregulation dismantled these initiatives or placed them under increasing pressures. The first steps toward financial liberalization were taken in the form of the removal of interest rate controls. Fears that financial systems could create fragilities and vulnerabilities were replaced by concern with "financial repression", that is, the notion that controlled financial systems depressed the returns to savers and thus led to lower savings and lower potential economic growth. In general, it was proposed that markets were better allocators of resources than were governments. This view was strengthened after the collapse of the planned economies of Eastern Europe and the disintegration of the USSR. Governments should "liberate" the energies of private entrepreneurs everywhere, including the financial market. The idea that unfettered financial markets could be a threat was replaced by the ideology that markets know best.

Intervention in financial markets, even of a prudential nature, was to be minimized. Even in the occasions where a clear and present danger could be identified, as in the case of the 1998 global liquidity crisis, regulators were reluctant to take any initiative. In particular, the Chairman of the United States Federal Reserve emphasized that regulations that impeded the development of innovations should be avoided. At the June 2007 meeting of the G8, the proposal of the German Finance Minister that highly leveraged financial institutions should be monitored was rejected by all the other financial ministers of the most advanced countries.

Currently, governments depend on "free" markets to pass favorable judgment on their policies. Domestically, if governments run fiscal deficits they depend on bond markets for their funding; so financial investors can veto policy strategies that do not please them simply by refusing to buy the bonds that allow the interested government to spend or by demanding higher interest rates that usually persuade the authorities to reverse their policies. This does not only happen in "small" countries. The famous affirmation by James Carville – President Clinton's pollster who invented the campaign slogan "it's the economy, stupid" – that he would like to be reincarnated as the bond market so he could taste *real* power is significant in this context.

In developing economies, financial liberalization led to mounting criticism of practices such as directed credit or development banks. According to the neo-liberal ideology, governments are supposed to act as regulators and impartial arbiters, without being otherwise directly involved in the economy. Despite the fact that developing countries grew when they were cut off from trade with developed countries and their governments adopted active and coherent development programs but stagnated when neo-liberal administrations took the lead and restrained their activities, the idea that remains dominant is that unfettered financial markets are more efficient to support development than regulation and intervention. In countries like Brazil, for instance, this leads to unrelenting pressures on the federal government, so far unsuccessful, to privatize the national development bank (BNDES) and to transfer its sources of funds to private banks.

International financial liberalization

If domestic liberalization exposes developed economies to the threat of increasing fragility and developing countries to stagnation, international liberalization may be even more dangerous.

As the neo-liberal argument goes, free world capital markets would contribute decisively to improve welfare worldwide. If capital could travel from the developed countries, where it is abundant, to the developing countries, where it is scarce and, thus, presumed to be more productive, investors in the rich countries would benefit because they would be able to reap larger benefits from their investments, and recipients in the poorer countries would also benefit because they would have more capital to develop their economies. If this picture were accurate, then the attempt of some nations to prevent the free movement of capital by maintaining capital controls would create losses for everyone.

That this argument is false is relatively easy to prove. Most developing countries were forced to dismantle capital controls in the early 1990s, either by demand of institutions such as the IMF, or by pressure from rich countries, especially the United States, or even by domestic initiative, with the rising influence of domestic neo-liberal movements. The dismantling of capital controls exposed the countries that implemented them to increased volatility and repeated financial crises, among other deleterious effects, with little, if any, perceptible gain in terms of economic growth. In fact, while neo-liberals stated that capital account liberalization would generate a better distribution of *productive* capital, it was *financial* capital that benefited from liberalization. Most countries already welcome productive investments while they maintained controls of the movements of financial capital. Liberalization, therefore, opened doors for the latter, rather than for the former. Financial capital does not search for opportunities to become productive capital. It looks for chances to enjoy what economists call “arbitrage” gains, that is, to profit from differences in interest rates paid in different countries or differences of prices of financial assets in different markets. This capital *never* becomes productive investment. It comes and goes from one economy to another much like locusts feeding on these differences, while leaving, in their wake, devastated balances of payments in those countries that received them. Again, this happens to developed countries as well; but in developing countries – where the size of the economy is small compared with the size of speculative capital flows – the losses can be catastrophic.

Poorer countries have more rigid demands for imported goods than the richer countries because of their lower productive capacity. Low-income countries depend on imports for food, but middle-income countries also depend on imports for raw materials and capital equipment. For many nations, export revenues are an essential source of revenues. Exchange markets are, thus, strategic for developing countries, rich and poor alike. Free capital movements tend to impart a high degree of volatility on exchange markets, disturbing the operation of developing economies. When liquidity is abundant in international financial markets, as is now the case, there is a surfeit of financial capital searching around the world for opportunities, overvaluing exchange rates in developing countries, making it more difficult for them to export and even to maintain their domestic levels of production in the face of competition from cheap imports. When the *market sentiment changes*, to use the immortal expression coined by former IMF director Michel Camdessus, outflows from these economies lead to balance of payments crises, rising interest rates and recession, as it was seen in the 1990s, in Mexico, Korea, Thailand, Malaysia, Brazil, Argentina, Turkey, Russia, among others. Flows of financial capital are much larger and quicker than flows of trade, so that, under capital account liberalization, they come to dominate the exchange rate determination.

A few developing countries resisted the siren songs of capital account liberalization and were able to avoid contagion from the 1990s crises. In fact, for a long time even developed countries didn't believe in the virtues of international financial liberalization. When the Bretton Woods conference was convened, when the end of World War II was near, the rules adopted by the winning countries, including the US and the UK, explicitly *demanded* the adoption of capital controls. Despite the failed attempt of the Fund to drop it in 1997, Article VI of the IMF's Articles of Agreement remains as a sort of fossil record of the initial belief in the need to restrain capital flows that create serious exchange-rate problems without any compensatory benefits.

The countries that did dismantle their capital controls and open their capital accounts soon realized that they would face financial markets much larger than their national boundaries. In fact, capital account liberalization is an essential piece of what is popularly known as financial globalization, the tendency to unify financial markets worldwide, creating forces that are able to overwhelm national states.

Open capital accounts and national autonomy

The worst effect of international financial liberalization is certainly the reduction of policy autonomy of national states *in the domestic arena.* According to this perspective, much more powerful than domestic liberalization per se is the opening of capital accounts to allow the free entry and exit of financial capital – thus subjecting a nation to the will of financial investors, national or foreign.

Opening capital accounts gives wealth-holders the opportunity to choose which laws to obey, which policies to follow. When a country allows free entry and exit of financial capital it is signaling to domestic wealth-holders that now they have a choice between complying with national law and moving their operations to a more friendly environment. It means that if a country's government decides to reduce interest rates to stimulate growth and employment in its economy, the owners of financial capital may decide to take their wealth to another, more attractive country, forcing the government to reverse its policy .

In fact, it is not only the power to decide on a monetary policy that is affected. A decision to impose progressive taxes, for instance, will have to reckon on the hostile reaction of investors. If the policy is unacceptable, they can simply flee with their capital to another country. This can happen with any policy that may displease rentiers and investors. In fact, most of the time it is not even necessary for capital flight to actually take place. The mere threat of initiating a capital flight episode is usually enough to intimidate national governments to retreat. Economic policy, thus, is no longer the province of democratically elected governments, because there is a particular constituency that can never be defeated. It is not just that wealth holders can avoid the burden of any policy they don't like. It is worse than that: in the process of evading local determinations, they can wreck an economy by causing a crisis in the balance of payments.

BRAZIL IN 2002

Brazil had a presidential election in October 2002. The two leading candidates were nominated by PSDB, a center-right party that had elected the outgoing president Fernando Henrique Cardoso, and by PT, a center-left party led by Luiz Ignacio Lula da Silva. By May 2002, it became clear that Lula was consolidating his leading position, making it more and more probable that he would be elected. In past electoral campaigns, PT and Lula himself had frequently questioned the economic policies adopted by sitting governments that they qualified as neo-liberal in character. When Lula's lead seemed consolidated, financial markets began expressing their discomfort with the prospect of a national left-wing government. Banks began selling government bonds from their portfolios and an episode of capital flight began, which rapidly took the exchange rate from about R$ 2.40 per US dollar to nearly R$ 4.00. Rising interest rates meant rising prices for imported goods and therefore rising inflation. Faced with the threat of a full-scale capital flight, added to a sharp rise in the risk premium on foreign credit lines, and rising inflation, Lula issued a Letter to Brazilian Citizens in which he publicly committed himself to maintaining the neoliberal economic policies adopted by Cardoso's administration. The commitment was actually honored: the new government appointed to both Brazil's central bank and Ministry of Finance economists and politicians connected with the banking system, who in turn implemented in Lula's first term the very conservative economic policies he had attacked as a candidate. President Lula himself ended up qualifying his own past anti-liberal rhetoric as the sort of *bragging* that a candidate is entitled to do while in the opposition, but which is not acceptable while governing a country.

The freedom to exit is complemented by freedom of entry. When a country accepts capital inflows without any restriction, it is contributing to the weakening the position of those countries that may suffer from capital flight. In fact, as already mentioned, the freedom of entry can also debilitate economies, by causing exchange rate overvaluation, making imports more competitive than local production, and destroying whole economic sectors and the jobs they generate.

What do neo-liberals say about these problems? They don't deny they may happen and are even likely to happen. They actually welcome them. In the neo-liberal jargon this means that markets will impose discipline on populist (read progressive) governments. In their view, interest rates are not high because this is demanded by wealth-holders who can make good the threat of fleeing the country with their wealth. Interest rates are high because one cannot trust governments, be they democratic or authoritarian, because governments seek favor from the population by offering public services that the country cannot afford. In fact, according to the neo-liberal view, countries can never afford anything, no matter how developed they are. Brazil or Argentina cannot afford social policies, or industrial policies, or investment subsidies, in the same way that the United States or Germany cannot afford social security or France cannot afford the 35-hour workweek. Yet according to the same view, opening capital accounts gives the power to financial investors to represent the people and show to governments that the people will not be fooled by populist measures just because the latter are in their favor. Thus, voting is not an efficient means to convey the people's real priorities, capital flight is.

: International financial liberalization and governance

Except for the lunatic fringes of neo-liberalism, however, even market-friendly economists and political leaders acknowledge that the operation of financial systems still creates important risks, including the risk of systemic crises. In fact, the experience of the last two decades has shown that no one is free from the risk of facing a serious financial crisis which, because of the international financial liberalization, tends to produce balance-of-payments crises. Of course, these crises are always more damaging to debtor developing countries than to creditor developed countries. As could be seen in the asian crisis, decades of social advancement and poverty reduction can evaporate very quickly. In 2001-2002, Argentina also showed how hard these crises can hit a country that had strengthened its defenses in the process of financial liberalization. One does not have to subscribe to any conspiracy theory about the role of financial investors to realize that giving financial markets and institutions full freedom to operate as they please creates unacceptable risks to rich and poor countries alike.

Financial globalization, however, creates a conundrum. Having permitted the constitution of markets that are literally larger than nations, the world has now to deal with the paradox that suitable regulation is a function of the body politic, a state function. To restrain the most destructive tendencies of financial systems would logically require a supranational state. The problem is that such a state does not exist.

ASIAN CRISIS

Up until 1997, asian countries such as South Korea, Taiwan, Malaysia, among others, were considered the most remarkable cases of success in transforming poor economies into modern, advanced economies. IMF had even decided to change the classification of countries such as South Korea, together with Hong Kong and Israel, to allow them to join its statistical category of advanced economies. Multilateral institutions such as the IMF and the World Bank formerly took credit for the rapid growth of the region, and saw these economies as examples of good macroeconomic policy implementation: they had avoided fiscal deficits and deficits in their balances of payment, had kept inflation low, produced for export, and so on. They were considered the visible example of the benefits of macroeconomic austerity.

However, the story was not so simple. These countries also showed how well planned government industrial and credit policies could sustain an accelerated process of growth. Also, many of these countries were illustrations of what could be accomplished without relying on the import of foreign capital, while maintaining some form of capital control.

These countries were subject to strong pressures to liberalize their capital accounts. When they succumbed to this pressure they became vulnerable to the sudden reversions of capital flows that characterize the modern international financial system. In most cases, the asian financial crises were *liquidity crises*, that is, crises that do not happen because the country is suffering from any particular economic deficiency. Rather, they were strictly financial market events, where some lenders recall their loans because they are afraid other lenders will do the same and there may not be enough money to satisfy all demands for repayment in the short run (because borrowers used the money lent to make productive investments that require some time to mature, so that they are illiquid until maturity). The crises were made worse by the remedy that the IMF imposed as a condition for lending these countries money to pay back foreign lenders. Fiscal expenditures had to be cut and interest rates raised, to “lure lenders back”. The fall in the demand for goods and services at a time when these economies were already suffering a confidence crisis was certain to cause, and did cause, deep recessions in the countries that accepted these conditions. Malaysia was the only country in the region that refused to comply; it instead adopted capital controls and reduced interest rates to stimulate economic recovery.

It should be noticed that the violence and depth of the recession suffered by countries like Korea, Indonesia, and Thailand quickly destroyed social gains in poverty reduction that had been painfully accumulating over decades.

ARGENTINE CRISIS

Argentina was another star pupil of the multilateral financial institutions in the 1990s. In 1991, after decades of high inflation, the Argentine government adopted a stabilization plan that included a *currency board*. A currency board is a monetary regime invented by the British to manage their colonies' currency. Its workings are simple: you only issue domestic currency to the extent that you have an equal value of a strong currency in your reserves. Thus, the value of national currency in domestic circulation is equal to the value of available reserves. If citizens don't have confidence in their domestic currency they can always exchange it for the strong currency. Thus, confidence in the strong currency *contaminates* the weak one. This means that Argentina, by adopting a currency board with the US dollar as the strong currency, gave up any possibility of choosing its own monetary policy. There would be as many pesos in Argentina as the amount of dollars that Argentina could earn or borrow. Therefore, Argentina had to export more and more or borrow more and more to be able to adopt pro-growth monetary policies and prevent interest rates from rising. The Argentine government opted for the second way, under the approving eye of the multilateral institutions. After a short period of success in reducing inflation in the second half of the 1990s, Argentina's dependence on foreign borrowing and the increase in its foreign debt caused concern. The support of the IMF, as usual, was obtained by implementing policies that restricted domestic spending. This reinforced a recession that had started in 1998, and caused the deep crisis of 2001-2002, during which national output fell almost 15% in one year and unemployment was widespread. It was only after Argentina declared a moratorium on its external debt, and adopted other non-liberal policies – including the reinstatement of capital controls – that it began growing again, at very high rates, allowing an expansion of employment and a reduction in poverty.

The first significant steps towards the formation of an international financial system were taken in the 1960s, with the emergence and rapid expansion of what was then called *Eurodollars*. Eurodollars were deposits denominated in dollars created in banks headquartered in places where they could not be regulated either by American or by European regulators. These markets were basically *self-regulated*, that is, regulation was set by the banks themselves.

Neo-liberals are in general friendly to self-regulation, arguing that no one knows better how a market works than its participants. These participants, in turn, will be more interested than others in building a solid and reliable system, because they depend on it for their continuing operation and are more agile than bureaucrats who are more concerned with keeping or enlarging their power than with preserving the market. Critics of self-regulation, on the other hand, point out that it frequently degenerates into cartel arrangements more concerned in keeping outsiders out; further, self-regulation tends to be complacent in the face of profitable but risky practices, especially those that are adopted by a large number of market participants. Critics also have pointed out that cartel arrangements are hardly prepared to address systemic risks that are usually out of reach of individual institutions, and lack effective powers of enforcement or of conflict resolution. Private banks, for example, may have serious difficulties in separating concerns about the general market from their own concerns about their individual competitiveness. In fact, doubts about the efficacy of self-regulating mechanisms were forcefully voiced by none other than Adam Smith the founding father of liberalism. It was Smith, not Karl Marx, who observed that every time capitalists congregate one might expect some conspiracy against public interest.

Be that as it may, even if neo-liberals and the interests they represent have not been successful in convincing the general public that public regulation of financial markets is a mistake and should be eliminated, they did succeed in preventing the extension of regulation powers to new markets and new kinds of institutions. It has already been noted that initiatives to extend regulation to highly leveraged institutions such as hedge funds have met with stiff opposition not only from the funds themselves but also from regulators in the main capitalist countries. A further problem in markets for derivatives is that over-the-counter (OTC) transactions made in private between two parties remain under-regulated or even unregulated, despite the general recognition that important systemic risks may remain unknown until they actually surface in the form of a crisis.

The alternative: the rise of international and multilateral institutions

Nature abhors a vacuum. In the absence of supranational states, and assuming that self-regulation is not a politically acceptable alternative, the space reserved for financial regulation in the global arena has been occupied by organizations that are international in character, even without having a political mandate to do so.

One would think that the most promising candidate to play the role of international regulator would be the IMF. Representing more than 180 countries, practically the whole world after the collapse of the Soviet bloc, with relatively well-defined, if limited, powers of enforcement, endowed with a formally defined (if perpetually criticized) decision process, and focused on financial problems at least since the late 1980s, the Fund would seem a natural candidate to become the international regulator that globalized financial markets require.

In fact, it seems that the Fund sees itself as a serious candidate for the job. At least since the short-lived Kohler administration, and more forcefully under de Rato, the Fund is trying to project itself as a kind of international *financial* supervisor, in charge of assessing the degree of financial stability of member countries with the goal of forecasting and preventing financial crises. How successful the Fund will actually be in this self-defined role is yet to be seen. However, it is clear that the Fund is not going to be the international *financial* regulator, that is, the *formulator of the rules* for establishing prudential regulation. The Fund is burdened by its qualities as well as by its defects. With more than 180 member countries, the Fund is too large a forum to decide on rules that developed country governments assume to be their responsibility. American, Western European and Japanese regulators are very little interested in the views of regulators in middle-income countries, let alone those of really poor countries. They may be willing to listen to some countries' "systemically relevant" suggestions, but they will not commit themselves to accept them, since their interests may (and probably do) differ from those of developing countries. The existence of formal processes of decision in the Fund only makes the problem more intractable: for as unfair and skewed in favor of rich countries as these processes are now, they still give voice and votes to countries whose opinions are not to be taken in consideration. The Fund can become, perhaps, an efficient *enforcer* of financial regulation – given that the content of this regulation is decided elsewhere.

To keep the participation in the relevant forums restricted to the countries that count, an informal channel was found in the Basle Committee for Banking Supervision, best known as the Basle Committee. Hosted by the Bank for International Settlements (BIS), the Basle Committee (BC) has since the 1980s been formulating the fundamental strategies that are to be employed in prudential regulation by banks and by financial conglomerates that include banks.

Membership in the BC is restricted to G8 bank regulators. This restriction is allowable because the BC's sponsoring institution, the BIS, is an *international* institution, not a *multilateral* institution. The BIS is actually a private institution, owned by a set of country shareholders. The BC is a consulting group, an informal organization without formal powers of decision or enforcement. As such, it makes *recommendations* that may or may not be accepted even by countries that are represented in the Committee, which is, as noted, not supposed to be representative. The BC only offers a consultative stance, so that countries with similar problems can discuss them and find common solutions.

In fact, despite being in existence since the 1970s, it was in the late 1980s that the BC rose to its position of main formulator of worldwide banking regulations. In addition, it does seem that this rise was somewhat accidental, unexpected even by the Committee itself.

ORIGINS OF BIS AND THE BASLE COMMITTEE

The Bank for International Settlements (BIS) was created in 1930 to manage the payment of war reparations by Germany to the Allies. These reparations were never actually paid, and BIS quickly became a meeting place for the monetary authorities of developed countries, where they could discuss common problems and strategies. Of course, the 1930s were not a propitious time for this type of activity; but after the end of World War II the BIS gradually assumed its modern functions. The Bank itself defines these functions on website <www.bis.org> as follows:

The Bank for International Settlements (BIS) is an international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks.

The BIS fulfils this mandate by acting as:

- a forum to promote discussion and policy analysis among central banks and within the international financial community;
- a centre for economic and monetary research;
- a prime counterparty for central banks in their financial transactions;
- agent or trustee in connection with international financial operations.

The BIS also “hosts” (again, in its own language) a few committees, among which we find the Basle Committee of Banking Regulation, created to allow an informal dialogue between banking supervisors of its members: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK and the US. The Basle Committee was created in 1974. In its mission statement, also found at the BIS website, the Committee stresses its informal nature, implicitly suggesting that it has no obligation to open membership to other countries:

“The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries’ supervisory techniques.”

The basle accords

In the late 1970s and early 1980s, the US banking system was undergoing numerous difficulties. The Latin American debt crisis, the savings and loan crisis, the energy loan crisis, among others, were all eroding the position of US banks, which were in turn facing increasing competitive pressures from foreign banks, particularly Japanese banks, even in the US domestic market. The strategies devised by US regulators to protect and recover the health of their banks involved a demand, as *quid pro quo*, that these banks shared the burden of recovery by contributing capital of their own in the process. It was believed that if a bank puts more of its own capital at risk in its operations it will be more risk averse in granting credit; and, in case of failure, in sharing the cost of reimbursing its creditors.

The demand that american banks commit their own capital in proportion to the size of their loans, however, put them in a disadvantageous position with respect to foreign banks that didn't face the same obligation. The concerns of these banks were voiced by american regulators in the forum in which they met regulators from those countries in which competitors were headquartered – the Basle Committee. A negotiation process was initiated whereby banks headquartered in other countries that competed with US banks would be put under requirements similar to those faced by american institutions. *Thus the Basle Accord of 1988 was born: as a competitive regulation directed at equalizing the costs of compliance with the capital regulation for internationally active banks.*

Basle I (as it became known later, when amendments and new versions began to be written) was a narrowly-targeted measure: it was directed at the very small set of large internationally active banks that competed in the same markets, so as to eliminate unfair competitive advantages resulting from differences in regulatory regimes. It was not supposed to be applied even to other banks in the countries directly involved in the debates, let alone the rest of the world. However, this was exactly what happened. By the early to mid 1990s, more than 120 countries had adhered to Basle I or stated their intention to do so after some transition period. The European Union even extended it to other financial institutions, which were not even considered by the BC.

Capital requirements became the new instrument of choice in prudential regulations. Now, the point of prudential regulation became to avoid bank bankruptcies, rather than protecting against deposit runs, and the best instrument was judged to be to make banks share the losses of a failure. After the initial voluntary adhesion of many countries, IMF made accepting Basle I, and its subsequent amendments the central criterion for recognition of best practice in prudential regulatory arrangements.

Basle I, however, was designed to be applied to the largest banks of the richest countries, but it became the rule of law for all banks in (almost) all countries. It was inevitable that in its application in so diverse situations all kinds of problems would emerge. Some of the problems were treated in an amendment added to Basle I in 1996. Nevertheless, a major overhaul of Basle I was soon recognized as necessary to create regulations appropriate for adoption in such a large number of countries.

The preparation of Basle II was marginally more democratic, since it was to be implemented in very heterogeneous conditions. A process of public consultation was opened: representatives of the industry and of those regulators that were not members of the BC were invited to offer their views. The decision process, however, was limited to the members of the Committee.

The result of this effort was announced in June 2004 (even though minor amendments continued to be added until 2005), and became known as Basle II. The text was subject to a large number of criticisms, ranging from its unbelievable complexity, to its incompleteness, to its omission of central prudential concerns in treating liquidity risks. It was also criticized because its design seems, paradoxically, to intensify cyclical fluctuations in the economy, rather than stabilizing them, and because it may increase the costs of lending to small and medium firms and to developing countries in general. Some of the most stinging criticism came from US regulators who – to the amazement of European regulators that had already transformed Basle II into a directive for the European Union – decided to apply a restricted version of Basle II to their banks.

BASLE II GENERAL FEATURES

While the first Basle Accord, signed in 1988, was very simple, stating that national supervisors should direct internationally active banks to maintain net worth (own capital) in the proportion of 8% of their risk-weighted assets (the weights being determined by the Committee itself, as appended in the Accord), Basle II is very complex. Besides setting differential capital requirements for different classes of banks, it also directs supervisors' actions and defines information disclosure requirements. Basle II relies on three "pillars": risk-based capital coefficients, supervisory review and market discipline. By far, the most important section of the new text refers to capital requirements. Banks are to be divided into two broad categories: less sophisticated banks will have to calculate their capital requirements according to evaluations of their assets provided by "external" agencies, such as ratings agencies. Banks that already possess more sophisticated risk measurement systems will be able to rely on information generated by the bank itself as inputs to the calculation of capital requirements. Among the more advanced banks, a further differentiation is made between advanced and less advanced banks, allowing the former to use more of its own data than the latter.

Supervisors are supposed to perform many more functions in the new system than in the past. They are supposed to evaluate the risk measurement and management systems, to assess the adequacy of banks' administrative structures in implementing their stated risk strategies, and to develop specific ways to deal with risks not explicitly treated in the new Accord, such as liquidity risks.

Finally, the third pillar, market discipline, lists the kinds of information banks that are required to disclose in order to allow markets to make their own evaluation of their risks.

Impacts of Basle II

The new prudential rules will have far-reaching effects, if they ever come to be fully implemented.

It has already been noted that Basle II may lead to more financial instability by making regulatory capital requirements more sensitive to risk. This means that in cyclical downturns, when credit risks naturally arise, banks will either have to increase their capital (it may be difficult to raise capital in a recession) or to curtail credit, worsening the situation for borrowers.

Also a prudential concern arises because the accord stimulates banks to adopt risk administration systems that are very similar in nature and may produce the same recommendations, worsening the problem of herd behavior (that is, there is the risk of having all banks acting in the same way when faced with a given event, because their decisions will result from the application of the same models) that generates so much financial instability.

The cost of credit may increase because of the complexity of the new agreement and the costs of compliance. It is likely, in fact, that these costs will increase more for small and medium banks than for large banks, which will benefit from many provisions of Basle II. So concentration in the banking sector may rise as a result of the agreement.

By the same token, foreign banks in developing countries will be favored because they will have the possibility of using models for which they already paid in their home countries, while local banks will have to bear these costs and, therefore, suffer competitive disadvantages.

Domestic supervisors will probably be overwhelmed by the demands of Basle II, particularly in developing countries. The complexity of rules and the number of new responsibilities attributed to supervisors by "Pillar 2" may cause them to "throw in the towel" and subscribe to whatever decisions a bank may present to them.

For developing countries, the impact may be even worse. If Basle II is taken as representing the "state of the art" in risk administration and is then applied to other financial institutions – such as, for instance, development banks –, its impact may be much more deleterious. Development banks are created to accept risks: that is, they are created for funding investments that the private sector judges too risky, supporting innovations, the modernization of economic activities, the creation of new sectors, etc. There is no reason for the existence of development banks if not to run risks that may be difficult to measure but which are, almost by definition, higher than those faced by commercial banks and other private institutions.

The central point, however, is not whether Basle II is bad or dangerous, which it may very well turn out to be. The important point is that its consequences are far-reaching, far beyond the "mere" question of financial stability (in itself important enough). But individual countries are expected to accept and implement those rules, even though they were not called to contribute to their elaboration. In this sense, there is an undeniable *democratic deficit* in the elaboration of the central strategies and dispositions of present-day financial regulation.

Other instances of democratic deficit

The case of the Basle Committee may currently be the most urgent, important and visible example of democratic deficit but it is certainly not the only one.

Governance rules in the IMF have been subject to intense criticism, some of which are acknowledged even by the institution itself. The attribution of votes to member countries follows a design established at the creation of the Fund, in the mid-1940s, which became more and more inadequate over time. The Fund works as a bank, in which countries are shareholders and have voting rights proportional to their shares – that is, to the capital which they contributed to the institution's "treasure chest". Created mostly as an institution to serve developed countries, which were expected to alternate in the positions of lenders to and borrowers from the Fund, this voting system was not particularly inappropriate at its inception. After the 1970s, however, countries became "specialized" in the positions of "donors" and "recipients", given that no developed country ever borrowed again from the Fund, and few developing countries ever made significant contributions to the treasure chest.

The Fund, therefore, became an institution that could be seen either as a provider of financial relief to developing countries or an enforcer of the policies determined by the richer countries, depending on the point of view of whoever looks at it. Regardless of an observer's point of view, it is obvious that the Fund is not democratic because voting power is not equitable.

There is currently an almost innumerable set of institutions that share international governance powers. In addition to the Basle Committee on Bank Supervision sponsored by the Bank for International Settlements, various standards have been promulgated by the IMF, the World Bank, the OECD, the International Accounting Standards Board, the International Federation of Accountants, the Committee on Payment and Settlements Systems of the BIS, the International Organisation of Securities Commissions, the Financial Action Task Force on Money Laundering, and the International Association of Insurance Supervisors. Some of them are more democratic, some of them are less; others, like the Basle Committee, are completely closed to non-members. All of them deal with questions that are very important in a world that, so far at least, has accepted the challenge of operating with globalized financial markets. Surprisingly, many governments, including some advanced countries that are not members of exclusive clubs such as the G8, seem to be oblivious to this problem. These governments act as if it were not in their interest to participate in such decisions, and as if the consequences of these processes did not touch their societies.

The need to act

It is thus time for civil society organizations to realize how important these problems are and to begin to putting pressure on national governments to assume a more pro-active behavior in these matters. The Basle Committee is an important example, but as important as it is, it is still just one instance of democratic deficit. Institutions such as the BC discuss and define policies that will affect directly the operation of all economies, because they affect how financial resources will be allocated in each society. Will it promote growth? Will it open access to credit and capital accumulation to small and medium firms that generate most of the employment in any capitalist economy? Will it allow access to savings products to the lower income groups of the population, contributing to a reduction in the concentration of wealth? These questions are just examples of problems that will be heavily affected by the decisions that are being taken in institutions such as the Basle Committee, among others, but that are closed, in greater or lesser measure, to the wide participation.

IMF has been a target of critical efforts by civil society organizations, and rightly so. However, this criticism has been mostly directed at specific problems, no matter how important they may be; as such, it has allowed other institutions to remain occult in the shadows. They are less well known, and they deal with more complicated problems; but this cannot be an excuse not to monitor their activities and not to demand that their decision processes be more open to scrutiny. It is important to realize that, while technical problems do require rigorous examination, a lot of what passes for complex technical argument is little more than mystifying jargon used to keep non-specialists away.

Of course, the starting point of such an effort has to be the diffusion of information among, and technical capacity building of, civil society organizations and activists to allow them to understand what is at stake, the nature and implications of each proposed strategy, and strengthening their powers to push governments into a more active posture to overcome the democratic deficit and to open effective channels of influence to advance the public interest.

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