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A NEW GLOBAL FINANCIAL ARCHITECTURE?

The early years of the twenty-first century have been characterized by generally benign global macroeconomic conditions.¹ The equity bubble has continued to expand, and the US recession many expected in the wake of 9.11 has failed to materialize. Growth rates in much of the developing world are at record-breaking levels, above all in China, trends which have helped the US sustain ballooning current-account deficits. As a result, according to Kenneth Rogoff, chief economist at the IMF from 2001–03, ‘the policy community has developed a smug belief that enhanced macroeconomic stability at the national level combined with continuing financial innovation at the international level have obviated any need to tinker with the [international financial] system’.²

Yet the world economy and interstate system are displaying signs of fragility that could easily tip the world into economic depression and geopolitical conflict. Firstly, the extraordinarily high and rising levels of debt to equity in the world financial system hold the potential for a ‘great unwind’. The assets invested in hedge funds have more than tripled in the seven years since 2000, to around \$1,500 billion. The CEO of a US hedge fund recently described the current situation as possibly ‘even more alarming’ than that which produced the crash of Long Term Capital Management in 1998: ‘the explosion of hedge fund investments in illiquid assets combined with leverage currently pose a greater risk to the global financial markets than we experienced at the time of the LTCM debacle.’³ Second, this run-up of debt reflects the boom in global liquidity—propelled by the surge in commodity prices since 2003 to the highest levels in more than two decades, the ballooning of the US current-account deficit, and the incorporation of giant savings pools in China and India into world capital markets. The liquidity boom has increased financial instability by enabling many developing-country governments to postpone improvements in financial regulation, as well as helping rebel groups to finance militias once they control a commodity-exporting base.

Third, we must take into account the precarious state of the US economy. Internationally, the US has in recent years been losing its position of economic dominance in both trade and finance, especially to the EU and China—European financial markets now have a higher capitalization than their US counterparts for the first time in a century. Domestically, the US middle class is being squeezed by falling house prices, spiralling mortgage foreclosures, declining real wages in manufacturing and lower-skill service jobs, and historically very high levels of debt to disposable income. Economic growth has slowed to near 1 per cent, while

¹ In addition to the cited references, I have drawn on discussions with Jane D’Arista, Jakob Vestergaard, Kevin Young, Charles Goodhart and Howard Davies.

² Kenneth Rogoff, ‘No Grand Plans, but the Financial System Needs Fixing’, *Financial Times*, 8 February 2007.

³ Janet Tavakoli, ‘Greater Global Risk Now Than at Time of LTCM’, letter, *Financial Times*, 7 May 2007.

the inequality of income between the top percentile of households and the bottom 90 per cent has reached its highest level since 1928. When the Great Depression struck, the US was in the ascendant. Being in relative decline today may make Washington more likely to react to these trends in an even more unilateralist, more defensive way than in the 1930s. The US has already begun to substitute bilateral and multilateral trade agreements, such as CAFTA, for commitment to the WTO process—allowing it to circumvent the WTO’s consensual procedures in order to establish agreements loaded with predatory provisions favourable to the US: open access for US agricultural exports, for instance, or stringent patent protection for US drugs.

Fourth, the relative decline of the US is part of a larger shift in the interstate system. In particular, the previously closed club of advanced capitalist states is under pressure to admit new challengers such as Russia, China and Brazil. The rise of such contenders has in the past almost always been accompanied by interstate conflict, and there is no reason to suppose that there will not be heightened geopolitical tensions and rivalries in the near future—though perhaps not on the scale of the twentieth century’s wars. In particular, neo-imperialism is again in the air—not only the US variety, but also the less noticed neo-imperial ambitions of Russia, based on its control over vast energy resources and raw materials and its consensual authoritarian rule. The tensions between these neo-imperialisms, especially over access to energy, have pushed the West to redouble its efforts to open markets in the rest of the world and reconfigure domestic political economies to facilitate the operations of Western, especially Anglo-American firms—with little more than lip service paid to the idea of compromise with the interests of developing countries.

The international financial system lacks the bodies that set standards and establish rules at the national level. But rather than implementing institutional reforms that might help to stave off further instabilities, in the decade that has elapsed since the Asian Crisis the West has sought to build a comprehensive regime of global economic standardization, surveillance and correction. Such areas as data dissemination, bank supervision, corporate governance and financial accounting have been subjected to greater scrutiny, through the concerted efforts of a range of actors: the IMF, the Basel Committee on Banking Supervision, the Financial Stability Forum, the G20 of finance ministers and a gamut of non-official bodies. Enforcement is to come largely through peer pressure and market reactions to information about compliance, so that countries, banks and firms which comply more closely with the standards gain better access to finance than those which comply less.

These rules—what I call ‘standards-surveillance-compliance’ system⁴—have been drafted by a US-led institutional complex, including Western governments and multilateral organizations such as the IMF, as well as financial firms and think-tanks from the advanced capitalist states; the global South, of course, has had almost no say. The resulting regime is only one part of a larger set of international arrangements which have the effect of redistributing income upwards—to wealthy industrialized countries, the financial sector, and the top percentile of world income distribution. But its impact has been far-reaching, pushing a range of national economies towards one particular kind of capitalism, and shrinking the scope of ‘policy space’ for these countries still further than did the prescriptions of the Washington Consensus. Where the latter insisted on liberalizing the market, deregulation and

⁴ A finer distinction might be made between standards which are set by international agreement, as in the executive councils of the IMF, World Bank, Basel, WTO etc., and unilateral actions by the US Treasury—such as classing certain banks or countries as dangerous to deal with—which in effect set standards.

fiscal austerity, the Post-Washington Consensus could be summed up by the commandment: ‘standardize the market’.

Crisis responses

The Asian Crisis raised fears that the whole world economy, including the biggest industrial countries, might be dragged down as the crisis ricocheted out of Asia and into Russia, Brazil and elsewhere. Alan Greenspan admitted in October 1998, in a speech to the National Association for Business Economics: ‘I have been looking at the American economy on a day-by-day basis for almost a half century, but I have never seen anything like this [‘this’ meaning the disintegration of market confidence].’ Stanley Fischer, deputy managing director of the IMF, explained that when the governor of the Brazilian central bank told him, in January 1999, that Brazil would no longer make an iron-clad defence of its exchange rate, ‘I thought, this is it. We’re going to lose Latin America, and then it will go back to Asia.’⁵

The Western policy-making establishment’s worries about the Asian crisis went far beyond the fact that it affected a sizeable portion of the world’s population in fast-growing and economically important countries. It seemed likely to discredit the hard-won consensus about the virtues of market liberalization and maximum openness for all developing countries. The crisis-affected countries in Asia had been regarded as star pupils of the Washington Consensus—indeed their economic success was routinely attributed to their adherence to the latter and held up as proof of its general validity.

Moreover, the crisis hit only three years after the dramatic Mexican peso devaluation of 1994, and Mexico too had been regarded as a star pupil of the Washington Consensus. Events there had spurred academics and official agencies to present proposals for safeguarding the world economy against a repeat, including better financial supervision at the international level, more transparency in financial markets, sensible macroeconomic policies and exchange-rate regimes, and better monitoring of macroeconomic performance. But once the fallout was restricted to Mexico, ‘complacency soon reasserted itself’.⁶ The shock of the Asian Crisis was thus compounded by the realization that nothing much had been done to strengthen the international financial system in the several years since the peso’s slump.

In view of Asia’s plight, leading policy economists tripped over themselves to offer up plans for a ‘new international financial architecture’ that would create a much stronger supranational authority in financial markets—a change of a similar order of magnitude to that initiated at the Bretton Woods conference of 1944. Proposals included ambitious new global organizations—a much larger IMF, a global financial regulator, a sovereign bankruptcy court, an international deposit-insurance corporation, even a global central bank. It was suggested that the IMF be given greater authority to support standstills—postponement of foreign debt repayments and even controls on capital outflows, equivalent to ‘bailing in’ countries’ private creditors—so as to give countries protection from creditor panics, analogous to the kind of protection that companies get from bankruptcy laws.

In the event, none of these proposals left the drawing board. The IMF has not been super-sized, as some analysts wanted, so that when crises erupt it could provide enough hard

⁵ Paul Blustein, *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF*, New York 2001, pp. 349 and 357.

⁶ Stijn Claessens, Geoffrey Underhill, Xiaoke Zhang, ‘Basel II Capital Requirements and Developing Countries: A Political Economy Perspective’, typescript, Center for Global Development, October 2003, p. 6.

currency for financial investors not to panic about a shortage of liquidity. On the other hand, it has not been abolished, as prominent conservatives like former Secretary of State George Shultz demanded, nor even substantially cut, as sought by the majority on a congressionally appointed panel led by conservative economist Allan Meltzer.

One of the more radical proposals to originate from the official sector—the Sovereign Debt Restructuring Mechanism proposed by Ann Krueger of the IMF, which contained elements of a global bankruptcy procedure—was defeated by a combination of developed-country states and private financial organizations in March 2003. This mechanism would have involved full debt restructuring: changes in interest rates, reductions in amounts owed, and influence over private investments and contracts. It would have entailed a substantial increase in the authority of an international organization over private financial markets.

There has not even been progress on the apparently more modest but still important proposal for institutionalized standstill procedures. Evidence from the crises themselves suggested that even ad hoc standstills could be very powerful in managing crises so as to reduce the damage to debtor countries. Though most bail-outs mounted by the IMF in the late 1990s failed, there were two that succeeded: the second rescue of South Korea, on Christmas Eve 1997, and the second rescue of Brazil in March 1999. The main difference between those that succeeded in stopping the panic and those that did not is that in the successful cases, the US Treasury, IMF and World Bank managed to cajole the Electronic Herd—mutual funds, pension funds, commercial banks, insurance companies and other professional money managers—to bail ‘in’ rather than ‘out’ and defer debt repayment, but did not do so in the more numerous unsuccessful ones.⁷

However, to get the authority needed for institutionalized standstills—and still more, any Sovereign Debt Restructuring Mechanism—the Fund would have to change its Articles of Agreement. Fund members however are extremely reluctant to make such changes, and had only done so three times before 1999. Major industrial countries would also have to pass laws recognizing the Fund’s authority, so that bondholders would be prevented from asserting claims in court. Any such laws recognizing the Fund’s authority inevitably encounter a storm of opposition, given that they involve authority to abrogate contracts—the covenants that govern borrowers’ obligation to pay interest and principal on loans and bonds—and authority to block a country’s own citizens, as well as foreigners, from moving their money abroad.⁸ The US Congress, in particular, would be sure to oppose this tooth and nail.

The proposal for Contingent Credit Lines was implemented, in that the IMF did create a facility enabling it, for the first time, to lend pre-emptively to help prevent a crisis. However, countries had to volunteer to join the facility, and the IMF had to certify its approval of their economic policies. In the event, no country signed up—to do so amounted to a confession of fragility—and even the IMF was unenthusiastic: ejecting a country which acquired a new government not to the Fund’s liking would send a bad signal to the markets, possibility precipitating a crisis.⁹

⁷ ‘Electronic Herd’ comes from Thomas Friedman via Blustein, *The Chastening*, p. 2.

⁸ Yet when mini-crises arose in Ecuador, Ukraine and Pakistan in late 1999 and early 2000 the Fund and the G7 did make official loan packages dependent on the willingness of those countries’ bondholders to permit a restructuring of their claims: Blustein, *The Chastening*, p. 386.

⁹ See IMF Fact Sheet, ‘Progress in Strengthening the Architecture of the International Financial System’, 2 July 2000. There have been no updates to this Fact Sheet since 2001, which speaks volumes; I thank Jane D’Arista for this observation.

In short, there been little movement on any of the more radical proposals for overhauling the international financial system. The central reason is the unwillingness of private financial markets to accept greater international authority, which would afford them less latitude than a world in which a variety of nation-states hold jurisdiction. There has, however, been significant impetus towards improving developing countries' ability to sustain a high degree of integration into the world financial system—on the implicit assumption that the cause of the crises lay with developing countries' weak institutions and practices, and not with the system itself. The real movement has therefore been in the area of global economic standardization: standards for good quality financial data or 'transparency', standards of best practice—including the Basel II capital requirements for international banks—and surveillance of national financial systems by multinational authorities, aimed especially at developing countries. The central thrust of this effort has been to further constrain policy-making and institutional arrangements in developing countries in order to ensure they fit the preferences of international investors for full openness, arm's-length relations between firms, banks, financial markets and government, and no government guarantees that might give banks an 'unfair' competitive advantage.

Drive for transparency

In October 1998, as the Asian Crisis was still unfolding, the G7 finance ministers and central bank governors declared agreement on 'the need for greater transparency'—echoing statements made after the Mexican peso's collapse. What was meant by this was the provision of 'accurate and timely' macroeconomic and financial supervisory data, including the reserve positions of central banks and levels of national public and private indebtedness.¹⁰ World Bank economists supported this line by arguing that the Asian Crisis was due in large measure to 'lack of transparency' in financial data. In the words of a World Bank paper published in 2001: 'The findings suggest that these countries did not follow International Accounting Standards and that this likely triggered the financial crisis. Users of the accounting information were misled and were not able to take precautions in a timely fashion'.¹¹

The IMF for its part argued in 2003 that the global 'adoption of internationally recognized standards of good practices [would help] foster financial market stability and better risk assessment'. Compliance with standards would supposedly help a country 'mitigate the impact of an external crisis by supporting continued access to external borrowing', and 'help prevent crises' by reducing the cost of foreign capital so that a government could 'remain solvent in cases it otherwise might not have remained solvent'.¹² The assumptions underlying these arguments naturally shield the IMF and World Bank from any blame: if they did not act to counter potential instabilities, it was because they had been misled by the Mexicans and East Asians.

The initial concern to improve 'transparency' grew into a broader thrust to reorganize and re-regulate economic activity around the world. This re-regulation had four main components: standards of good information; standards for best practice, covering banking supervision,

¹⁰ G7 Statement on the world economy, Declaration of G7 Finance Ministers and Central Bank Governors, London, 30 October 1998.

¹¹ Tara Vishwanath and Daniel Kaufman, 'Towards Transparency: New Approaches and Their Application to Financial Markets', *World Bank Research Observer* 16, 1 (2001), p. 44.

¹² IMF, 'Review of Contingent Credit Lines', Washington, DC 2003, p. 26.

payments systems, corporate governance and financial accounting; systematic surveillance of economies in order to judge compliance with standards; and mechanisms for encouraging governments and firms to comply.¹³

The Financial Stability Forum was established in April 1999 with the G7 finance ministers and central bankers at its core, plus those from four other industrial countries (or territories, in the case of Hong Kong), together with representatives from the IMF, World Bank and Bank for International Settlements, and private-sector associations of financial firms. Its purpose was to develop standards in the domains of banking supervision, risk-management systems for banks, financial accounting and corporate governance. The Forum was chaired by the general manager of the Bank for International Settlements, and it included no representatives of developing countries.

The IMF was charged with developing Special Data Dissemination Standards, mainly for macroeconomic data, and was itself to be the primary enforcer of many of the standards, through formal mechanisms of structural conditionality, contingent credit lines, and negotiations around Article IV of the IMF's Articles of Agreement, which details states' obligations relating to currency stability. However, these formal enforcement mechanisms were never developed, for the same reason that the more radical of the 'new international financial architecture' proposals were not developed. Instead, the IMF—and the 'transparency' thrust more generally—relied on indirect enforcement through the response of 'financial markets'—the Electronic Herd. The Fund would make public directly, or indirectly via the government, the results of this surveillance; financial markets would respond to the high-quality information appropriately, lending more funds at cheaper rates to governments that complied more closely with the standards, and less at higher rates to governments that complied to a lesser extent. Knowing this market-driven reward and punishment system, governments would strive for greater compliance, and the international financial system would become more stable.

This was the theory behind the 'standards-surveillance-compliance' system. In line with this theory, the IMF and World Bank started in 1999 to produce Reports on the Observance of Standards and Codes (ROSCs), and undertake a Financial Sector Assessment Program (FSAP). Between 1999 and the end of 2006 the IMF produced 502 Reports and the World Bank 92, making a total of almost six hundred. One hundred and thirty countries had at least one ROSC. The Reports fed into the larger exercise of the FSAP, which had three main components: compliance with standards, stability of the financial system, and the financial sector's required reforms. Operationally, the FSAP exercise may entail, for a large country, the arrival of a sizeable team of people from the IMF and World Bank, along with outside consultants, who then have detailed discussions with financial authorities on such critical matters as payments systems, feeding back their findings to the authorities.

At much the same time, on a separate but parallel track, the Basel Committee on Banking Supervision, under the umbrella of the Bank for International Settlements—the club of rich-world central banks—was developing a new set of standards for bank capital and banking supervision. The impetus came from bank regulators' feeling overwhelmed by the financial innovations of the 1990s, and from the development by banks of new kinds of risk-assessment

¹³ My argument here is indebted to Jakob Vestergaard, 'Managing Global Financial Risk? The Post-Washington Consensus and the Normalization of Anglo-American Capitalism', typescript, Centre for the Analysis of Risk and Regulation, LSE, June 2007; and Vestergaard, *Discipline in the Global Economy: Panopticism and the Post-Washington Consensus*, Copenhagen 2007.

models—coupled with the prevailing norm that ‘markets’ and not regulators know best. Formulating the new set of standards came to be known as the Basel II process, the successor of Basel I, now seen as out of date. The initial Basel II proposals were published in 1999, the Asian crisis having given the project added urgency. In addition to the Financial Stability Forum, the IMF’s data-standards drive and Basel II, a whole gamut of unofficial private-sector bodies have also been formulating standards with global reach. They include the International Association of Insurance Supervisors, the International Accounting Standards Board, the International Organization of Securities Commissioners, the International Organization for Standardization, and the International Federation of Stock Exchanges.

New standards at work

The FSAP assessment team typically concentrates on ‘supervising the (national) supervisors’—examining how the national financial supervisory system is working and making suggestions for improvement. Often its political role is to strengthen the hand of regulators. Fearing international criticism and market discipline, a number of governments have overhauled their financial regulatory system ahead of an FSAP exercise, especially when the government has undertaken in advance to publish the FSAP’s findings. Even where the findings of the exercise are not made public, market participants can find out readily enough if they wish to.

This must however be seen in the context of a whole series of negative effects. First, the reports and assessments have generally been compiled as check-lists to be completed. As one involved World Bank official put it:

The problem with the FSAP is that the shareholders, primarily G7, burdened it with doing a huge amount of mindless assessments of compliance with a large number of standards. This prevented and/or distracted staff from looking at first-order issues. For example, in [an Eastern European country] two successive heads of the sec were assassinated by ‘defenestration’ from their office windows. Yet the FSAP concentrated on their compliance with IOSCO [International Organization of Securities Commissions] standards, even though with this degree of lawlessness, it is difficult to expect any securities market activity except for trade among insiders. Such silly exercises took resources away from consideration as to why some markets were missing or malfunctioning. The British, the French, Canadians, and Americans were the worst in their relentlessly check-list approach.¹⁴

In other words, the country assessments tend to focus in great detail on ‘structural’ issues rather than on the prime concern, external stability.

Second, the Fund does not devote enough time and effort to overseeing the system as a whole. According to the IMF’s Independent Evaluation Office, its operational staff often do not read the global stability reports, let alone integrate these findings into their bilateral work. Only 14 per cent of senior staff said that the IMF’s ‘multilateral surveillance’ findings were discussed with national authorities.¹⁵ Conversely, bilateral surveillance reports contain little discussion of policy spillovers from systemically important countries such as Germany, Russia or even the us.

Third, it seems that financial-market participants generally pay rather little attention to the data provided through ‘transparency’ exercises—even though they would presumably no

¹⁴ Anonymous, April 2007.

¹⁵ Independent Evaluation Office of the IMF, ‘An Evaluation of the IMF’s Multilateral Surveillance’, February 2006, available at www.imf.org.

longer be ‘misled’ by the data as they supposedly were before the Asian crisis. A recent independent evaluation of the FSAP concluded that ‘while many authorities identified the “signalling role” to markets as one of their motivations for participating in the FSAP exercise, the impact of FSSAs [Financial Sector Stability Assessments] on the views of financial market participants appears modest’.¹⁶ Financial markets pay more attention to ‘traditional’ macroeconomic indicators like inflation than to compliance with standards of good financial practice. Studies of the link between compliance with standards and cost of foreign capital have found no significant impact of the former on the latter.¹⁷ If financial markets do not pay much attention to the data from surveillance exercises, the IMF’s mechanism for enforcing best practice—which relies on financial markets rewarding high-compliance countries and punishing low-compliance policies—will not function at all.

Fourth, to the extent that markets do pay attention to the information made available through transparency exercises, the effect may be to make financial markets less stable and more prone to crisis. By homogenizing data about economies and reducing the diversity of opinion on the near future, these exercises may accentuate the tendency to pro-cyclical herding behaviour—bankers and investors buying what others are buying and selling what others are selling.

Compliance, too, is variable. In some countries, a post-crisis surge of formal compliance was followed by regulatory forbearance and selective enforcement. In general, compliance with the Special Data Dissemination Standards for macroeconomic data has been highest, since this is relatively easily monitored, and private firms do not bear the costs. Next highest was banking supervision. Compliance with the standards of corporate governance and financial accounting was lowest, as these are most costly to the private sector as well as hardest to monitor. Of the four East Asian countries affected by the 1990s crisis, Malaysia had the highest overall level of compliance, followed by Korea, Thailand and, at the bottom, Indonesia.¹⁸

What about the impact of the Basel II standards, which started to be implemented in early 2007? It is quite likely that these, too, will generate pro-cyclical tendencies and raise the volatility of borrowers’ access to bank finance. Avinash Persaud, former head of research at State Street Bank, argues that Basel II’s move towards more quantitative and market-sensitive risk-management practices reinforces herding behaviour and market volatility in a vicious circle.¹⁹ One reason is that the Basel II standards encourage the more sophisticated banks—those based in developed countries—to adopt a single type of internal ratings-based model relying on current asset prices, which tend to be pro-cyclical; this raises the capital requirements at times of downturn, precisely when banks are less able to meet these requirements. A second reason is that banks will tend to react similarly to similar signals—

¹⁶ Independent Evaluation Office of the IMF, ‘Multilateral Surveillance, Evaluation Report’, 2006, p. 13, and ‘Report on the Evaluation of the FSAP’, 2006, p. 57. See also IMF, ‘The Standards and Codes Initiative—Is It Effective? And How Can It Be Improved?’, 2005. The latter reports that the use of ROSCs by market participants is low, and has not increased in recent years.

¹⁷ [reference?]

¹⁸ Andrew Walter, *Governing Finance: East Asia’s Adoption of International Standards*, Ithaca, NY forthcoming, chapter 7.

¹⁹ Avinash Persaud, ‘The Disturbing Interactions Between the Madness of Crowds and the Risk Management of Banks in Developing Countries and the Global Financial System’, in Stephany Griffith-Jones and Amar Bhattacharaya, eds, *Developing Countries and the Global Financial System*, London 2001, p. 61. Also Boris Holzer and Yuval Millo, ‘From Risks to Second-Order Dangers in Financial Markets’, CARR Discussion Paper, London School of Economics, 2004, p. 17.

because they are using the same type of risk-assessment model, which leads them to downgrade or upgrade clients en masse.²⁰

Anglo-Americanization?

Standards of best practice are rarely distributionally neutral: they benefit some participants more than others. The standards established by the Basel Committee, the IMF, the FSF and the like—and surveillance in line with the standards—may be having at least two far-reaching impacts that are disadvantageous for developing countries and advantageous for developed countries, especially those following the Anglo-American model.

Firstly, Basel II—as compared to Basel I—will shift competitive advantage even further towards developed-country banks and against developing-country banks, and will likely hurt development prospects more broadly by making developing-country access to finance more pro-cyclical. Basel II requires banks with less sophisticated risk-management systems to carry relatively more supervisory capital than banks with more sophisticated systems. It therefore raises the former's costs of lending relative to those of the latter, which tend to be based in developed countries. These banks are allowed to establish their credit risks and capital adequacy themselves—'self-supervise'—subject to the financial supervisor approving their model. Basel II also requires bigger differential risk weighting for lower-rated borrowers, who are disproportionately from the global South—giving insufficient recognition to the risk-diversification benefits of lending to clients in developing countries.

The Basel Committee's own most recent quantitative impact study reveals a large variance in the amount of capital required for banks using the different Basel II-based risk-assessment methodologies. For example, some banks using the 'advanced internal ratings-based' approach—predominantly in developed countries—are expected to have large *reductions* in their capital requirements, of the order of 30 per cent. Banks using the simpler 'foundational' approach—predominantly in developing countries—are expected to experience an *increase* in their capital requirements of over 38 per cent.²¹ The Basel II standards thus give a structural advantage to large developed-country banks, and a structural disadvantage to developing-country banks; and hence also to the regional, national and local economies within which these are nested.

The upshot is that developing countries under Basel II could face a higher cost of capital and a lower volume of lending than under Basel I, with more pro-cyclical volatility, and with their banks less able to establish international operations and more likely to be taken over by developed-country banks.²² No country should let its banking system be taken over by foreign banks, even if Western banks are likely to be more 'efficient' in developing countries than domestic ones: in times of crisis, banks rely heavily on their home base, and are likely to sacrifice operations in developing countries in order to protect it.

A further far-reaching impact of the new standards and surveillance mechanisms lies in their tendency to create a global 'attractor' point, in the sense of taking the Anglo-American or liberal market economy as the 'normal' or 'proper' kind of capitalism.²³ This involves short-

²⁰ Claessens et al., 'Basel II Capital Requirements'.

²¹ Basel Committee on Banking Supervision, 'Results of the Fifth Quantitative Impact Study', 16 June 2006, p. 2.

²² Claessens et al., 'Basel II Capital Requirements', p. 17.

²³ Vestergaard, 'Managing Global Financial Risk'.

term and arm's-length relations between banks, non-financial companies and the state; non-discretionary regulation which is delegated to 'independent' agencies, like the Financial Services Authority in the UK; and banks oriented to maximizing profits. A contrasting type has been common in East Asia, based on longer-term and more 'multiplex' relations between companies, financiers and the state; discretionary regulation; and some banks invested with social purposes beyond profit-maximizing, such as development banks. This system was an important factor in the very high rates of investment and diversification in capitalist East Asia from the 1950s to the 1980s, particularly because it enabled big firms to carry much higher levels of debt to equity than their counterparts operating within an Anglo-American framework. High debt-to-equity ratios supported high rates of investment.²⁴

As long as the East Asian system operates on the basis of long-term relationships, patient capital and government guarantees, Anglo-American capital is at a disadvantage in these markets. On the other hand, US and UK financial firms know they can beat all comers in an institutional context of arm's-length relations, stock markets, open capital accounts and new financial instruments. Therefore the Asian system must be changed to more closely resemble theirs. An example of this is a Foreign Operations Appropriations Bill passed by the US Senate in September 1998, stipulating that no US funds be made available to the IMF until the Treasury Secretary certified that all the G7 governments had publicly agreed to make IMF require its borrowers to liberalize trade and investment, and eliminate 'government directed lending on non-commercial terms or provision of market distorting subsidies to favoured industries, enterprises, parties or institutions'—that is, eliminate sectoral industrial policy. Moreover, when an East Asian economy adopts the standards of best practice favoured by Western governments and multilateral financial institutions, its banks have to operate under much tighter prudential standards, and cannot support debt-to-equity ratios anything like those they sustained earlier. This puts pressure on the whole chain of savings, credit and investment, and curbs the rate of investment.

The Basel Committee's rules illustrate the mechanism by which the 'standards-surveillance-compliance' system pulls towards the Anglo-American model. The rules have as their ostensible purpose the enforcement of a uniform level of prudence sufficient to make bank failure and contagion unlikely. Prudence is defined in terms of levels of a bank's assets, liabilities and core capital. Hence the Basel Committee's rules of prudence translate into rules about capital adequacy. But in a national economy where banks receive government guarantees, they have to mobilize less capital for their operations. This has been the case with banks in Japan and other East Asian countries, with German *Länder* banks and development banks in the Third World. These are different from the kind of banks assumed in the Basel rules: they are not devoted solely to maximizing profits for their shareholders, and government guarantees allow them to support a cross-subsidizing mixture of public and private purposes, and to operate with a trading ethic that does not force them to drop unprofitable borrowers overnight. The IMF, World Bank and leading industrial economies, however, consider such banks to have an unfair competitive advantage, and want them to behave like 'normal' banks, without government guarantees—which means giving up any public purposes.

In other words, what seem to be rules of prudence are actually rules for forcing convergence to the Anglo-American model. Moreover, since financial systems are sub-systems within a

²⁴ See Wade, *Governing the Market*, Princeton 2004; and John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change*, Ithaca, NY 1983.

larger institutional complex, changes in the former will have ramifications for related institutional areas, including corporate governance, product markets, labour markets, and further on into the welfare state and education. Thus, in so far as the West is able to get its standards of best practice accepted as 'normal', and non-compliance as 'deviant', it alters the international political economy in a manner that might be compared to global warming—away from coordinated market economies and towards a liberal market economy of the Anglo-American type. Efforts at surveillance on the part of wealthy countries, the IMF and World Bank should not be understood as a mere supplement to previous efforts at market liberalization. The drive for 'transparency' involves not so much 'removing the veil' as a massive programme of standardization, thereby reinforcing and legitimizing the power of the G7 states and multilateral organizations to intensify and stabilize financial liberalization.

Can this shift in the political economy of developing countries towards the liberal or Anglo-American type be justified in terms of improving their prospects for growth? Answering this fully would take us beyond the limits of the present article. But it is undeniable that historically, a diverse range of institutional arrangements have succeeded in stimulating economic growth, with varying levels of state involvement. The US and Britain, moreover, perform badly on many non-GDP-based performance indicators compared to equally rich countries with more coordinated market economies.

A false freedom

Since the Asian Crisis, the multilateral financial institutions and G7 governments have continued to place the onus on developing countries to prevent crises, without changes being made at the international level to mitigate the pressures from global financial liberalization. They have rejected such measures for reducing the severity of crisis as the Sovereign Debt Restructuring Mechanism, and standstills more broadly, as well as blocking—albeit with certain qualifications—the use of capital controls by developing countries. Instead, in the name of liberalism, the West has sought to construct a global regime of economic standardization, the effects of which will include the entrenchment of the structural advantages enjoyed by financial organizations in the global South, the contraction of policy options for developing countries, and pressure on these national economies towards adopting an Anglo-American model.

The 'standards-surveillance-compliance' system thereby exemplifies a familiar paradox of liberalism: under the banner of economic freedom—expanding market participants' freedom to move their finance where they wish and use it as they may—it imposes a single policy model from above, curbing the ability of nation-states to choose their own path. And by virtually excluding developing countries from standards-setting forums, the High Command prevents those who are subject to its decisions from having any role in how these are made. In that sense, the revised structure of the international financial system is designed to replicate across the globe policies that will generate further crises, while preventing its architects from being held to account.