

Servicing emerging markets? The regulation of global capital flows

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Abstract

The emerging global financial system after the fall of Bretton Woods enabled especially middle-income countries to increase their sovereign borrowing. This opportunity was seized on by financial services providers, leading to the rapid internationalisation of the financial services sector. The growth and globalisation of the financial system was accompanied by recurring financial crises with grave consequences for the affected societies, however. This paper will analyse the regulatory regime for this domain of the global financial services market, with a special focus on the interaction between public and private actors. Based on a case study the policy area of sovereign debt crisis resolution, it will be argued that a transnational policy network is emerging in this domain. This transnational policy network is comprised of public and private actors and facilitates a shift in governance from domestic-based public regulation towards international, market-based patterns of governance. Internationalised financial services companies play a crucial part in the negotiations on this new pattern of governance, while the interests of developing countries seem systematically underrepresented. The analysis will be underpinned by a comparison of the governance patterns in response to the Latin American debt crisis of the 1980s and the Mexican and East Asian crises of the second half of the 1990s. The Latin American debt crisis was resolved by a solution brokered by the US as the dominant financial power. This was based on ad-hoc state-based restructurings. In response to the East Asian financial crisis, the major policy proposal came from an international organization (the IMF's Sovereign Debt Restructuring Mechanism) and would entail a global public regulatory regime. Fierce opposition from the financial services industry, however, led to the defeat of this proposal in favour of market-led solutions.

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1. Introduction

After the fall of Bretton Woods, international capital flows (including emerging market sovereign debt flows) increased rapidly. This growth and internationalisation of the financial system has been accompanied by recurrent crises, however. The effects of these crises are not restricted to the financial sphere but also impact the socio-economic structures of the affected countries. According to one study, the typical financial crisis reduces the affected country's GDP by 9%.² The globalisation of the financial system also enabled rapid spill-overs and contagion of financial crises, leading to global repercussions. Most pronounced examples of these global financial crises were the early 1980s Latin American debt crisis and the late 1990s East Asian crisis. The financial difficulties do not only spill-over to vulnerable debtor countries, but can also translate into financial difficulties for the creditor countries (usually OECD) once the financial crises become big enough (so-called systemic crises). This is a direct transmission mechanism pulling creditor countries into the policy debate on financial crisis resolution. A second transmission mechanism raising the interests of creditor countries in financial crisis resolution is the increasing interdependence in international economic relations. The negative economic effects of crises on debtor countries also resonate in the real economies of creditor countries through for example reduced export possibilities.

Given the important global socio-economic effects of large-scale financial crises there is a continuing search for a system of governance aimed at greater financial stability. As contemporary history shows (most recently in the Argentinean meltdown), however, an adequate policy response has not been formulated yet. Financial markets seem to remain prone to crises. Given the evident urgency of this issue, what then precludes the formation of a more comprehensive pattern of governance or regime aimed at financial stability? This paper will address this puzzle by analysing how the level and form of governance of sovereign debt crises has changed since the 1980s Latin American crisis up till the Asian crisis and its aftermath. Its main question will be how to explain the developments in the level and form of governance? Special focus will be on the interaction between private and public actors in the governance of the financial services sector.

It will be argued that the response to the Latin American debt crisis was an ad-hoc, state-based resolution of the sovereign debt crises. The strategy was promoted and effectively led by the American Treasury, and did not lead to new global level rules for governing the market. In the period after the Asian crisis, on the other hand, proposals for the development of a global level regime for sovereign debt crisis resolution gained traction. This regime is not only aimed at the direct resolution of the Asian crisis, but is forward looking and would lead to a distinct change in the way global financial markets are governed. It can be said that in the eventual pattern of governance emerging in the beginning of the 21st century, the territorial focal point of governance in a multilevel framework has shifted upward.

² Although there are differences among studies due to definitional factors and data problems, the 9% figure of Bordo et al. (2001) seems broadly in line with other empirical studies.

Effectuation of this pattern of governance is delegated to negotiations between domestic public actors and financial services firms, however.

This leads to the second argument, regarding the form of governance pattern. Since the 1980s a shift to more private (market-based) forms of governance has occurred. While the leading creditor states emphasized regularly the leading role of the IMF in the various responses to the Latin American debt crisis, the new forward-looking pattern of governance developed after the Asian crisis is based on the market relations between debtors and creditors, and only sets the framework for the negotiations between these market actors, as opposed to public interventions in the market. While in the policy-making process after the Asian crisis distinctly public forms of governance were given serious consideration (notably the IMF's Sovereign Debt Restructuring Mechanism (SDRM) proposal), these public forms were defeated by the market-based proposals.

These shifts in the level and form of governance came about as a consequence of political struggles in an emerging transnational policy network. With the globalisation of financial markets, also a global policy community emerged. An advocacy coalition of internationally active financial services firms, International Organizations (like the IMF), and their domestic level public counterparts managed to take over the policy network in the process. Many parties representing developing countries or other societal interests lost voice in the policy-making process as a consequence. The strong representation of private sector interests at this level, combined with relatively limited democratic accountability of public sector representatives leads to a preference for market-led financial governance mechanisms. Levelling of the international playing field (in other words, expanding 'fair competition' on global markets) gains preference over typical domestic features of financial markets and other societal interests.

However, a pure interest-based political explanation of the dynamics of this policy-making process does not suffice. An important element of the interaction in this policy network is ideational. It is not argued that this transnational policy network is an epistemic community, rather it is an expert community as described by Ikenberry.³ It is the common background and outlook of the members of this policy network that lead them to a common problem definition (market failures) and common standards for the solutions (improving financial market efficiency). This ideational element is based on a common educational background and the frequent interaction and more importantly role-changes of the public and private actors in the policy-making community. It is very common to see officials of the IMF, ministries of finance and central banks to make the change from the public sector to important financial services firms and lobby groups and vice-versa.

In the policy-making community dealing with the governance of global capital flows many initiatives and actions are taken in response to the large-scale financial crises. The so-called global financial architecture debate is broad. To limit the scope of this analysis,

³ Ikenberry, 1992.

proposals in the debate can broadly be categorized into measures aimed at preventing crisis, and measures aimed at the orderly resolution of crisis. Measures aimed at preventing crisis are either focused on strengthening the functioning of financial markets (increasing transparency, the Basel Capital Accord) or on bolstering countries against 'irrational' financial markets (e.g. by making the IMF a Lender of Last Resort or by capital controls). Crisis resolution measures aim to deal with the situation emerging after a crisis has broken out, to restore the 'normal' functioning of the global financial system with the least possible economic damage to its constituents. This includes measures to facilitate debt work-out procedures for sovereigns or for example measures to improve the effectiveness of IMF conditionality. This paper will focus on the proposals regarding crisis resolution.

A second limit to the scope of the analysis is the focus on sovereign financial crisis resolution in countries with private market access, usually middle-income countries (also known as 'emerging markets'). The paper is not concerned with the debt problems of countries whose main source of financing are official capital flows (low income countries like sub-Saharan Africa). Given the focus on the interaction of public and private actors, the second category of countries is not useful since the private financial services sector does not play a role. Both these limitations are also empirically represented by separations in the policy-making processes on these two issues. For example a high level decision making body of the IMF, the International Monetary and Financial Committee (IMFC) after the East Asian crisis always had separate points on the agenda for crisis prevention and crisis resolution, and the policy-making process on the sovereign debts of low income countries often took place in different forums (with much more inclusion of ministries for development cooperation).

This paper contributes to the literature on global financial governance by its focus on the interplay between public and private actors instead of a relatively state-biased approach.⁴ Furthermore, the theoretical framework emphasises the importance of the ideational component in political struggles on governance, thereby building on the traditional interest-based political science literature. The systematic comparison of the post-East Asian crisis initiatives with those from earlier periods of financial turmoil is an empirical contribution to the literature since many recent contributions only focus on the developments after the East Asian crisis, without putting the developments in patterns of governance in their historical context.⁵ To understand the developments in global financial governance, this historicized empirical work can unearth the grand thrust of shifts in governance over the daily nitty-gritty political struggles over specific policy proposals such as the SDRM.

2. The political economy of the governance of global financial services

⁴ For example Kapstein, 1994 and Wood, 2005.

⁵ See for example Eichengreen, 1999; Lukauskas & Rivera-Batiz (eds), 2001; and Noble & Ravenhill (eds), 2000. For an exception, see Helleiner, 2006.

Any discussion on the governance of global capital flows and the services firms which shape these markets should start out with conceptualising global financial governance. In this paper, global financial governance refers to the norms, rules and procedures by which (international) financial markets function. Traditionally, political science looked at 'government', for example the Bretton Woods system where public authorities (nation-states and the IMF) governed monetary policy-making. However, global financial governance encompasses more than just public authority. Private sector self-regulatory organizations or supranational entities also play an important role in functional international financial markets. The main value-added of this conceptualisation of global financial governance is that it broadens the scope of research from a focus on public, state-based actors to all actors that are involved in the operation of the (international) financial system. Furthermore, the conceptualisation also encompasses less tangible aspects of organizing society: not only policies (rules) but also, for example, norms. Both these advantages allow for a better insight into the political struggles and power issues involved in global financial governance. The use of 'governance' underscores that International Political Economy is not only about power struggles between states, but also about power struggles between public authorities and the private sector, and within the private sector itself.

The governance of global financial markets takes place at several levels, hence a multi-level governance framework applies. This "gives expression to the idea that there are many interacting authority structures at work in the emergent global political economy."⁶ Depicting governance as multi-level allows for a subtle distinction between the national and international level, and draws attention to other levels not easily captured in pure territorial terms.⁷ It should be noted that the term 'level' does not necessarily imply a hierarchy among for example the national level and the regional level. On the other hand, even though the levels exist next to each other, that does not mean shifts in governance do not take place from one level to the other. An example would be the dissolution of the Bretton Woods system, when the responsibility for monetary policy was shifted back from an international US/IMF-based system to individual states increasing the importance of the domestic level for understanding the governance of monetary policy.

In the application of a multi-level framework, the different shifts in governance that can take place should be disentangled. Lumping together shifts between 'territorial' levels and between 'authority structure' levels leads to fuzzy analyses. As mentioned in the introduction, in this analysis two dimensions of governance will be distinguished therefore: the (territorial) level of governance and the form of governance. Over being an analytical tool, the choices made on these two dimensions have implications for the accountability and legitimacy of

⁶ Baker, Hudson & Woodward, 2005, p. 14. See the whole edited volume by Baker, Hudson & Woodward for an elaboration of the concept of multi-level governance in the context of financial governance.

⁷ For example Cox's 'nebulose' (Cox, 1996, p. 298) or the use in this paper of *transnational* policy community.

global financial governance.⁸ While public institutions are usually accountable to the population through the democratic process, private institutions are usually accountable to otherwise specified constituencies (or might have only a limited accountability structure).⁹ As another example, it could be argued that the absence of a global polity hampers the input legitimacy of global level governance arrangements.¹⁰

The first dimension in the governance of global financial markets concerns the level of governance in a territorial sense: are there global rules and norms (and accompanying institutions), or does the governance of the financial system remain within the purview of states? From a state-based perspective, global financial governance could be analysed as an 'international regime' or a pattern of cooperation among states.¹¹ However, as will be shown later, there are global level actors which seem to have an independent position of their state constituents. On the public side, the IMF for example has its own role in the maintenance of certain international norms.¹² Moreover, international banks and their global lobby group (the Institute for International Finance, IIF) have their own function in global financial governance.

The second dimension refers to the nature of the institutions built for maintaining a working financial system. On a fundamental level, governance is always an ensemble of both public and private regulatory authority, coming out of the 'public' policy-making process *and* the competitive interactions of firms. States and markets are parts of an integrated ensemble of governance. The integrated ensemble of governance runs from private market transactions to public government (e.g. enforcement of property rights). In between, there is a continuum of overlapping institutions which have specific properties and important consequences for the distributional effects of governance and its legitimacy. However, we can thus distinguish a continuum from governance through more public-based institutions through to governance mainly based in private institutions. For example, in the conduct of monetary policy, usually the domestic central bank is the main governing institution. This is arguably a mainly public governance institution. On the other hand, in global accounting standards the main governing institution (IASB) is a private entity. In the continuous interaction among agents in the financial system, the balance between 'public governance' and 'private governance' changes, for example due to the interaction between public and private actors in the policy-making process or exogenous changes in market structures.

Patterns of governance can be mapped along these two dimensions. In figure 1 below this is translated in a 2x2 matrix, although in reality the dimensions are (almost) continuous. A domestic level, public pattern of governance would be banking supervision in the Bretton Woods period. Going up the territorial level, the Bretton Woods monetary system is an example of a global level, public pattern of governance dealing with monetary policy. On

⁸ See for example Porter, 2002.

⁹ Of course non-democratic regimes are not accountable to their populations. However, in the field of financial governance, truly autocratic regimes tend to play a marginalized role.

¹⁰ Held, 1996.

¹¹ Krasner, 1983.

¹² Pauly, 1994.

the private side of the matrix, the governance of securities exchanges (before the internationalisation of this regime) is a domestic-level example. A global level, private pattern of governance currently receiving a lot of attention is the governance of accounting standards. These standards are drafted by a private body, the International Accounting Standards Board (IASB).¹³ Although the aforementioned examples are static, this does not intend to imply that patterns of governance are. Over time, shifts in the patterns of governance can occur, as the case evidence will show.

Figure 1. Global financial governance and its dimensions.

Form of governance	Private	Security exchanges (historically)	IASB
	Public	Banking supervision during Bretton Woods	Bretton Woods
		Domestic	global

The question then becomes how a specific pattern of global financial governance ends up in one of the cells of the matrix, and what would cause this pattern to change over time across the two dimensions?

A first strand of theory dealing with these issues sees changes in governance as a functionalist response to (external) changes in market structures.¹⁴ This view is especially prevalent in the International Economics literature. The initial position in the matrix is determined by presumed rational economic actors maximizing their utility. This would lead to social optimality through the guidance of the 'invisible hand', with governments making equal rationally based governance decisions. The focus lies on giving market actors the right 'incentives' to optimise the functioning of the market (including preventing and managing crises). Thereby the balance of the 'public' and 'private' forms of governance is determined. The public part of global financial governance (state interventions in market transactions) is explained from functions necessary for keeping the market functioning.

In the International Economics literature two main reasons for public forms of governance are elaborated: market failures and transaction costs. Financial markets are specifically prone to a number of market failures. First of all, financial markets exhibit asymmetric information problems. The entity demanding funds has more information on the way it is going to use those funds than the provider of funds has. Therefore, providers need to monitor the actions of the borrowers to ensure timely repayment. This process is usually facilitated through financial intermediaries. Second, the use of a shared form of money is like a collective good: the value of it for an individual is dependent on other people using it as well

¹³ Perry & Noelke, 2005.

¹⁴ A prominent example (inter alia) is Kapstein, 1994.

and more specifically the trust people have in the currency. This propensity of money provides an argument to grant the right to issue money to a monopolist. This is usually a public central bank, but private forms of money provision do exist as well.

The functionalist view on the territorial level of governance would presume that governance would be determined at the level at which it can be provided most efficiently. If for example market failures spill over borders, a supernational solution would be necessary. There would be no specific reason to solve domestic problems of one country at the global level.

The dynamics of patterns of global financial governance is explained by functionalist theory by exogenous innovations in the global financial system. The huge growth of international portfolio investments would for example be explained as a consequence of innovations in information and communications technology making cheap international transactions possible. Innovations by financial services providers are likely to lead to new market failures and externalities, and hence require new governance patterns. For example, the shift from syndicated bank lending to sovereigns in the 1980s to international banks acting as intermediaries for securitised sovereign debt (an innovation of international banks) led to aggregation and free rider problems if a sovereign had debt problems. As will be discussed in the case study below, new patterns of governance were proposed to deal with this situation.

An important drawback of this explanation, however, is that it fails to take into account the political context of financial governance. Even if the pattern of governance is determined by rational utility maximizers seeking to optimise the functioning of global financial markets, political issues remain. First of all, the economy is often characterised by multiple equilibria. As a typical example: in international economics it is theorized that the typical resolution of a sovereign debt crisis consists of a combination of three elements: emergency official financing, domestic policy adjustments, and so-called private sector involvement (private sector refinancing and/or restructuring of existing debts).¹⁵ Functionalist theory cannot answer the question what the balance between these three elements should be. Any decision on the balance between these three elements is deeply political as it determines who pays what, where, and when. Hence it makes the governance of sovereign debt crisis resolution inherently political, with the eventual balance depends on the power of the various actors in the policy-making process during the crisis resolution efforts.

Secondly, changes in market structure are not as exogenous as the theory would lead us to believe. For example the internationalisation of international financial markets was only possible because of the political decision to liberalise financial markets and open domestic capital accounts. Subsequently, emerging international banks led to the need for a new vision on banking supervision firstly elaborated in the first Basel Capital Accord.

Thirdly, market-actors themselves are rent-seekers and hence not necessarily interested in competition. The political and regulatory process at the (inter)national level is as much a part of business strategies as is investment and marketing. On the other hand, while

¹⁵ Roubini & Setser, 2004.

states regulate the international financial system, they are at the same time active as market participants sourcing their financing needs from market parties. Firms simultaneously deploy their political and competitive resources to achieve the outcome they seek. Assuming that the process of competition is somehow separate from the deployment of political resources by firms which aim precisely to affect the pattern of competition by establishing a favourable regulatory framework, is incorrect. In combination with the market-imperfections mentioned before, this implies that without institutions governing competition, markets would soon falter in the face of collusion, monopolies, and rent-seeking in general. The ways in which markets are structured, the sorts of values embedded in the prevailing regulatory systems, and which actors/organizations are able to develop within the prevailing incentives, make all the difference to the nature of the (international) financial system that emerges.

To push the three aforementioned political issues in global financial governance further: explanations offered by functionalist portray political institutions as an external intervention into market dynamics. There is an inherent notion of a dichotomy of states and markets. This dichotomy makes no empirical sense, however. The institutions of the market and the institutions of the policy-making process should be integrated into the notion of what a market is. Political institutions are interdependent on certain constituencies, patterns of governance developed in the policy-making process reflect the interests of constituencies of market agents. The optimal form and level of intervention may prove politically and socially unworkable, and the *actual* form and level of intervention will not be determined by optimality conditions thereof. In the international policy forums in which the governance of the international financial system is discussed, the central goal of the participants is not so much optimization of the international allocation of resources, as it is to further the (economic) interests of certain specific constituencies. To explain the developments in global financial governance, the dynamics of changes in market structures and the political interactions constituting these markets must be explained. Hence, an IPE approach overcoming the state-market dichotomy is needed. As emphasized above, however, we should not make the mistake of subsequently only looking at public authority exerted in the global financial system. It is the interplay between the exertion of public authority and private market transactions which is the first step towards an explanation.

This requires an analysis of the constellation of actors in the governance of the global financial markets and the interaction between them. Here, the concept of policy communities and policy networks is a usual tool.¹⁶ A policy community refers “to the participants in the governance structure and the degree and pattern of integration among them.”¹⁷ Policy communities form around specific ‘dossiers’, specific policy problems. In the current paper, the policy problem is the resolution of sovereign debt crisis with participants ranging from

¹⁶ In the policy network / policy communities literature there seems to be quite a diversity of conceptualisations, even to the point of turning the policy community / policy network distinction around. The following discussion is based on Coleman & Perl, 1999; and I stick to their conceptualisation. See also Coleman & Skogstad 1990 and Dowding, 1995.

¹⁷ Coleman & Perl, 1999, p. 695.

NGOs to private financial services firms to public authorities. Within the policy community groups can emerge which members have an extraordinary strong level of shared beliefs, values and norms. These groups often provide a framework for political action as advocacy coalitions.¹⁸

In the policy community, there is a specific subset of actors who can reach authoritative decisions: the policy network. In the conceptualisation of Coleman & Perl public authorities need to be involved in this policy network because only decisions by public authorities are considered binding on society (and can be enforced by the use of legitimate force).¹⁹ The conceptualisation here diverges from this by not making the involvement of public actors a necessity for the policy network. Various types of policy networks can be distinguished, but for the discussion in this paper, the question about which actors are actually involved in the policy network is more important. Keeping members of the policy community with diverging interests out of the policy network is one of the most effective ways of improving the chances of getting one's own preferences satisfied and is therefore a first stage of political struggle concerning global financial governance. Whether the negotiations in the policy community are conceptualised as another form of class struggle or as a more pluralistic setting, those who are left out of the policy community have basically no way of satisfying their interests in global financial governance.

A final strand of literature that needs to be addressed when analysing global financial governance deals with the role of ideas. The field of global financial governance is especially conducive to ideational elements in its theories because of the evidently subjective nature of the empirical subject at hand.²⁰ In this paper, the focus lies on the explanatory role of ideational factors in the actual interaction within the policy community. More fundamental poststructuralist challenges as for example elaborated by Marieke de Goede will therefore not be addressed.²¹

As mentioned, within the policy community groups can emerge with strong levels of shared beliefs, values and norms (advocacy groups). It could be argued that a special type of these advocacy groups are epistemic communities.²² An epistemic community is "a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area".²³ The influence this epistemic community can exert over the outcome of the policy-making process is hence not so much an outcome of material capabilities, but of their knowledge base. The members of an epistemic community are usually thought to be standing independent from the formal decision-making bodies in the policy community (e.g. a group of academic scientists),

¹⁸ Sabatier, 1988.

¹⁹ Coleman & Perl, 1999, p. 696.

²⁰ Dodd, 1994. See also de Goede, 2003 for a post-structuralist view on IPE with a focus on finance. Examples of empirical applications of (partly) ideational explanations are Ikenberry, 1992; Pauly, 1994; and Verdun; 1999.

²¹ De Goede, 2003.

²² Coleman & Perl, 1999. These authors go even further and claim that the two concepts are the same.

²³ Haas, 1992, p. 3.

but actively advocate a specific policy solution based on their agreement on a set of scientific causal claims regarding a policy issue.

A less restrictive application of this literature is Ikenberry's approach to ideational factors in policy communities.²⁴ In his view, certain advocacy coalitions are connected by a common definition of problems and a common yardstick to measure possible solutions against. These groups do not have to be independent from the policy network, and can even be actively created by it. If such an expert group can control the policy network, it can narrow the range of possible developments regarding global financial governance, because policy solutions which do not fit their problem definition and/or 'yardstick' are not seriously considered. These expert groups (somewhere in between the common denominator of advocacy coalition and epistemic community) can form as a consequence of a common background in educational and professional life.

To summarize, the theoretical framework developed here leads to explanations of changes of global financial governance based on a combination of material interests, institutional contexts and ideational factors. Based on this combination, actors wage a political struggle in the policy-making process concerning global financial governance. This struggle proceeds over two stages: those who are in the policy network and who are not; and the political trade-offs within the policy network. In the empirical material laid out below, it will be argued that over the course of the two major global financial crises, the struggle in the first stage was decided in favour of a transnational policy community with a common background and rationalistic view of the financial system. In the second stage, this led to shifts in governance to the global level, and towards more market-based governance arrangements.

3. The resolution of sovereign debt crises

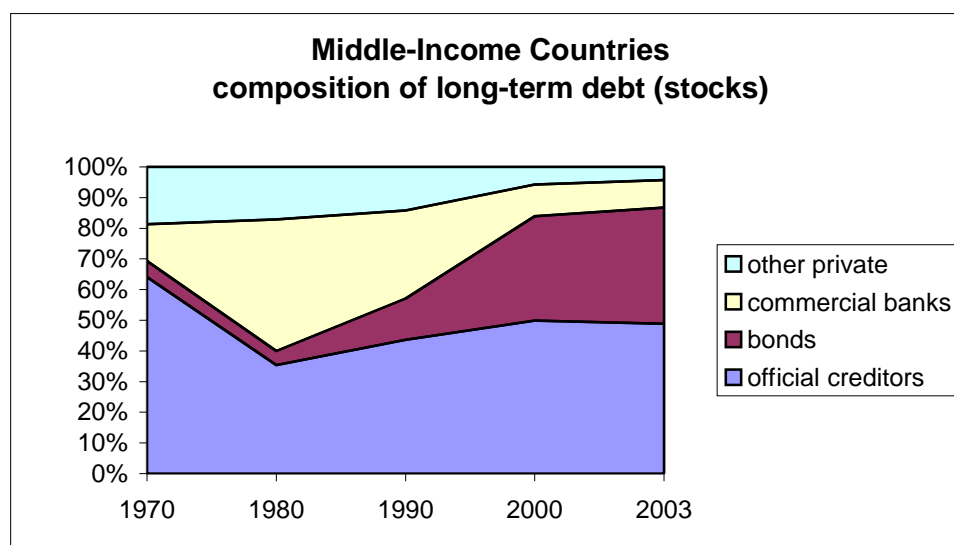
In this section, the theoretical framework elaborated above will be applied to a case study of the resolution of sovereign debt crises. In figure 2 below, the developments in the composition of sovereign debts for middle-income countries over the period of analysis are shown. As can be seen, the rapid internationalisation of the financial services industry after the fall of the Bretton Woods monetary system in the early 70s greatly expanded the possibilities for middle-income countries to gain access to private credit. This led to a gradual expansion of the share of bank loans in the debt stocks of middle-income countries. These loans were put together by syndicates of banks, often involving dozens of banks worldwide. In the early 1980s, a global recession, rising real interest rates, and declining terms of trade for debtor economies combined to produce big difficulties for the debtor countries to repay their debts.²⁵ In the summer of 1982, Mexico was the first emerging market to declare it could no longer repay its private loans. Several other, mainly Latin American, emerging markets followed and the Latin American debt crisis was born. As can be seen in the figure, the share

²⁴ Ikenberry, 1992.

²⁵ Gilpin, 1987, p. 318.

of bank lending to middle-income countries was gradually reduced in response the debt crisis. Middle-income countries increasingly began to source their private credits directly from the capital markets by emitting international bonds. The banks, still struggling with the outstanding debts, made the strategic choice to act as intermediaries in sovereign debts rather than to act as end holders of debts.²⁶ This development diversified the creditor base of sovereigns, and complicated the coordination between creditors in a possible sovereign debt crises (as became abundantly clear during the 1995 Mexican crisis).

Figure 2. Composition of long-term debt of Middle-Income Countries



Source: World Bank, *Global Development Finance 2005*

In the following two subsections, the policy responses to the sovereign debt crises of the period, as well as to the developments in the composition of long-term debts, will be analysed. Two episodes of global financial turmoil are distinguished: the resolution of the Latin American debt crisis of the 1980s and the policy reactions to the financial crises of the late 1990s (Mexico and East Asia). It will be shown that the composition of the policy network dealing with the Latin American crisis was in important ways different from that dealing with the East Asian crisis. Where in the 1980s the policy network could be distinguished in a domestic level and an international level (in the IMF) component, by the 1990s a transnational policy network had emerged. This is also reflected in the policy proposals advocated for dealing with these sovereign crises. The Latin American debt crisis was resolved by a number of succeeding US-led plans working on a case-by-case basis. In the aftermath of the East Asian crisis, on the other hand, forward looking global level solutions were proposed.

The Latin American debt crisis

As mentioned above, a number of macroeconomic circumstances in the late 1970s conspired to lead to severe difficulties for many middle-income countries to repay their debts.

²⁶ De Carmoy, 1987, p. 15.

This culminated in the declaration by Mexico in the summer of 1982 that it could no longer repay its private loans. When several other, mainly Latin American, emerging markets followed a financial crisis with global repercussions had started. The crisis caused severe economic hardship in the affected debtor countries, for example real per capita GDP fell by 4,8% in 1983 in the countries with debt servicing problems.²⁷ However, the crisis went beyond that: it emerged that the global banking system was at risk. International syndicates of banks had lent large amounts to the emerging markets now in debt distress, to the extent that outstanding loans were much larger than bank capital. These exposures were unevenly divided among the major creditor states, however (see figure 3). With the American banks most heavily indebted and as the leading economy of the capitalist world, the US took the lead in addressing this debt crisis (as will be elaborated below).

Figure 3. Exposure of Western banks to the HD17²⁸ (percentage of capital)

	1982	1985	1987	1992
France	n.a.	126.6	62.8	22.7
Germany	31.4	50.7	33.5	18.5
UK	85.0	68.6	42.4	n.a.
US (all banks)	130.1	86.6	63.6	26.7
US (9 largest banks)	194.2	140.1	106.6	50.6

Source: Cline, 1995, tables 2.10 – 2.14.

With the global financial system at risk, the resolution of the crisis was taken up by an international policy community. On the public side, members of the policy community consisted of ministries of finance and central bankers from the debtor states and from the large creditor states (basically the G10).²⁹ Another important public actor in the policy community was the IMF, which also provided the main international negotiation forum for the public actors. On the private side, the banks with exposure to the debtor countries had an important interest in the discussions on solving this policy problem. Finally, several prominent academics got involved in the debates. For example in 1983 already, prof. Kenen of Princeton University floated a proposal for the establishment of a new international organization, the International Debt Discount Corporation, which would buy private sovereign debts at a discount (a 10% haircut) and then reschedule the debt on advantageous terms for the country.³⁰

²⁷ Sachs, 1986, p. 399.

²⁸ The HD17 refers to 17 highly indebted countries identified for inclusion in the Baker plan (see later on). These countries accounted for 51% of total developing country debts, and were: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia (Cline, 1995).

²⁹ The G10 consists of the members of the G7 plus Belgium, The Netherlands, Sweden and Switzerland (curiously enough adding up to eleven). The origin of this group lies in a 1962 agreement to back-up the financing of the IMF (the General Arrangements to Borrow).

³⁰ Kenen, 1983. I specifically mention this example because members of the US House of Representatives took up the proposal.

Despite this broad international policy community, the first response to the crisis seems to be led by the material interests of the creditor states: the protection of the solvency of Western banks. Effectively led by the US Treasury, the balance between public refinancing, domestic adjustment and private debt restructuring tilted towards domestic adjustment in the debtor states. This was in line with the opinion in the majority of the banking community, which was of the view that “with appropriate interim lending programs and country adjustment effort the debt on banks’ books will be shown over time to be sound.” Only a minority thought debt write-offs to be necessary.³¹ Efforts focused on domestic adjustment, combined with official financing. In October 1982, the IMF Managing Director (de Larosiere) announced to a meeting with bankers that the IMF would only provide emergency financing to Mexico if the private sector did so as well. These IMF loans would of course have conditionality attached, emphasizing domestic policy adjustment. In subsequent finance packages for debt-distressed countries, the IMF continued to emphasize co-financing by the private sector.³² This co-financing did not necessarily entail a net flow to the debt-distressed countries, however. As can be seen in figure 3 above, this allowed banks in fact to reduce their exposure over time. Another effect was a steadily rising proportion of official debt in the debt stock of emerging markets.³³ It is furthermore noteworthy how the resolution of this crisis was led by the public sector, and then specifically the US Treasury. The negotiations of the international policy network took place in the IMF’s Executive Board and Interim Monetary and Financial Committee (IMFC). This weakened the bargaining position of the affected debtor countries because of their limited voting share in the IMF.

By the mid-1980s, the effects of this initial round of IMF packages with private sector co-financing began to wear off. The private sector did not have an incentive to start lending completely voluntarily (without IMF moral suasion), however. This led to new liquidity problems, as the policy adjustments in the debt-distressed countries did not provide the desired sustained economic growth and the relatively short-term IMF loans came due. At the same time, a new team had taken over at the US Treasury, headed by Secretary Baker. The new team set out to design a more systematic program for dealing with the debt distressed countries, which was put forward in the international policy network at the October 1985 IMF/Worldbank Annual Meeting in Seoul.³⁴ The Baker plan acknowledged the fact that growth in the debtor countries would have to be increased if they were to fully repay their debts. The methods of the Baker plan were very much like the earlier procedures dealing with the crisis on a case-by-case basis, although with more emphasis on long term rescheduling debts (‘private sector involvement’) and renewing capital inflows (amongst others by a greater involvement of the World Bank and regional MDBs).

³¹ Bergsten, Cline & Williamson, 1985, p. 22.

³² Cline, 1995, p. 205/206.

³³ See also figure ~~XX~~ above. It must be pointed out, however, that the share of official financing in the early 70s was much higher than any time after.

³⁴ Cline, 1995, p. 207/208.

It should be noted that the Baker plan was only reactive to the Latin American crisis, not a forward looking governance design for the global financial system. From outside the policy network, such governance redesign proposals were made as for example the aforementioned proposal by Prof. Kenen. These proposals often also entailed a different trade-off between debtor adjustment and private sector involvement and would have levelled authority to a global level. Despite the fact that the Kenen proposal was endorsed by two members of the House of Representatives (Morrison and LaFalce) it was never taken up by the US Treasury. The bill instructing the Treasury to do so had as a caveat that the proposal should not affect the current or future value of sovereign claims, a caveat which was used to focus on the Baker plan instead.³⁵ Following the lead of the US Treasury, the G7 continuously promoted a case-by-case approach emphasizing domestic policy adjustment and a central role for the Bretton Woods institutions (excluding proposals for new global level public entities).³⁶ The G7 furthermore unequivocally and explicitly supported the Baker plan.³⁷

The Baker plan was publicly supported by commercial banks in the US, UK and Japan. The use of more or less the same wording in their declarations of support indicates coordination between these major financial centres. Continental European banks were more muted in their support because they did not agree to the new financing commitments under the Baker plan.³⁸ With the passing of the initial shock of the crisis and the start of the more systemic Baker plan, divisions within the banking community increasingly began to show. Within the US, the big US money-centre banks (which had the highest exposure) had a strategic interest in continued business with emerging markets, while smaller mainly domestic US banks wanted to get out of the business completely. At the same time, across the creditor nations, differences in tax and reserves policies between US, European, and Japanese financial regulators led European and Japanese banks to be increasingly resistant to new lending. European banks fought for better representation in the creditor steering committees, and were more inclined to capitalize interest payments coming due instead of providing new money.³⁹ Although American banks provided on average 35% of private loans to Latin American debtors, their representation on the creditor steering committees of the six major creditors was from 45% to 58%. The Institute for International Finance (IIF) had already been founded as a business association of the international banks cooperating in the assessment of sovereign risks, but apparently was not yet involved in advocating a coherent policy at the international level.⁴⁰ Hence, from the private side definitely there was no contribution to a transnational policy network.

With the dangers to the (especially American) banking sector diminishing, attention of the US government for the implementation and successful conclusion of the Baker plan also

³⁵ Cline, 1995, p. 226.

³⁶ G7 communiqués throughout the 1980s, obtained through the website of the University of Toronto G8 information centre: www.g7.utoronto.ca.

³⁷ G7 communique, May 6, 1986, para 10.

³⁸ Wiegand, 1988, p. 36.

³⁹ Wiegand, 1988, p. 9.

⁴⁰ Porter, 2002, p 9.

diminished. This led debtor governments to take a more pro-active stance, with Brazil declaring a moratorium on interest payments in the beginning of 1987.⁴¹ Brazil subsequently proposed a long term solution to its debt problems by securitising a large part of its outstanding loans and new funding against market rates (without risk premium).⁴² In discussions with private banks from Europe and the US, this solution was outright rejected. This rejection was forcefully joined by the US Treasury Secretary, leading to the abolition of the plan. As a sign it would not be intimidated by the new assertive stance of debtor nations, in May 1987 Citibank set aside some US\$ 3 billion in loan-loss reserves against the Latin American loans (25% of its exposure), soon followed by other US and British banks. Although partially aimed at showing the banks were prepared for a fight with debtor countries, it also sent the message that banks no longer valued the sovereign debts at full value (consequently driving down secondary market prices). This was a significant change in attitude of major US and UK banks, undercutting their previous stance that any restructuring could not lead to losses for banks and that the IMF-led case-by-case approach would be enough to restore creditworthiness. Banks in continental Europe had already gradually built up reserves during the crisis, due to various reasons (tax-deductibility, accounting and reporting standards, and less emphasis on shareholder value concerns). Thus the continental banks were only lukewarm supporters of the US/UK stance.⁴³ But although many continental banks were in favour of more radical proposals reducing debt and setting up international organizations, they failed to form one bloc. Furthermore the US Treasury and IMF exerted pressure on their home governments to go along in the US-led scheme. Finally, due to their linkages with the American banks, they were vulnerable to influencing by the large US banks. This manoeuvring by the commercial banks, but more importantly the struggle of debtor and creditor public state-actors, was the prelude to the third and final phase in the resolution of the Latin American debt crisis: the Brady plan.

In response to the rising tension on the debt issue, the American government intervened again. This time the new US Treasury Secretary Brady drafted a plan shifting the balance from domestic adjustment to debt forgiveness from the private sector and increasing official financing. With this plan, he also swept aside the more radical proposals coming from the House of Representatives and ignored governmental voices from continental Europe in favour of more radical solutions. The debt forgiveness under the Brady plan was “premised on a voluntary, market-oriented approach to debt reduction. It wisely rejected any type of mandatory reduction”.⁴⁴ It used public-sector funding to collateralise new bonds, which would include private sector debt reduction. The IMF was allowed to lend into arrears, increasing debtor state leverage vis-à-vis private creditors. Again, it should be noted that this plan was not a diversion from the contemporary governance-arrangement, but an ad hoc solution.

⁴¹ Shepherd, 1994.

⁴² Wiegand, 1988, p. 4/5.

⁴³ Wiegand, 1988, p. 15 and 20/21.

⁴⁴ Cline, 1995, p. 218.

After forceful pressure by the US Treasury on private sector banks, the first Brady deal was concluded with Mexico in July 1989, including a 35% haircut (nicely in the middle of the initial Mexican position of 55% and the private sector's offer of 15% haircut). By May 1994, deals had been completed or announced with 18 countries, heavily overlapping with the HD17. Haircuts under these deals were mostly similar to the Mexican deal. The Latin American debt crisis could be considered as resolved. As the evidence from this episode shows, the actors in the policy community were decidedly state-based and the policy network dominated by the American Treasury.

The Mexican and East Asian crises of the second half of the 1990s

As apparent from figure 2 above, after the Latin American debt crisis emerging markets began increasingly to source their finance not only from banks, but also directly from the capital markets by emitting international bonds.⁴⁵ This diversified the creditor base of sovereigns, complicating the coordination between creditors in a possible credit event. In the mid 1990s, this became abundantly clear with the 1995 Mexican crisis, a systemically important emerging market. Under a fixed exchange rate regime, Mexico received large capital inflows in the beginning of the 1990s. When the sentiment of traders on the global capital markets changed due to domestic political turmoil and an unfavourable external macroeconomic environment, capital flight occurred. After an initial attempt to defend its peg, Mexico was forced to leave the fixed exchange rate regime, while in the meantime having incurred an unbearable level of external debts. As this financial crisis originated in the capital markets (and not so much from bank credits), it was dubbed the first financial crisis of the 21st century.

After the outbreak of the 1995 Mexican crisis, the G7 Heads of State summit in Halifax commissioned the G10 to draft a report on the orderly resolution of crises. To things are noteworthy in comparison to the earlier Latin American debt crisis. First of all, although on the public side the creditor countries remained in the driving seat, efforts were not led by the US Treasury this time but broadened to the G10. Second, the G10 officials were to draft a forward-looking report instead of come up with an ad hoc response to the crisis. Although the G7 summit had also discussed an important contribution to the policy discussion by high-profile economist Sachs (which revived the idea of an international bankruptcy court to deal with sovereign debt crises), the G10 working group decided to opt for a more market-based alternative. In their August 1997 report they advocated adding collective action clauses (CACs) into international bond contracts.⁴⁶ The report explicitly emphasized that "international bankruptcy procedures and other formal arrangements do not appear to provide, in current circumstances or in the foreseeable future, a feasible or appropriate way of dealing with

⁴⁵ Although it must be acknowledged that bank financing in one form or the other remains an important part of the external debts of emerging markets, see Roubini & Setser, 2004.

⁴⁶ Helleiner, 2006, p.15. The report also made the familiar call for policy adjustments in debtor countries to prevent crises.

sovereign liquidity crises.”⁴⁷ The CACs were thought to be a ‘practical’ (achievable) solution, also because they were already market standard in the international bond market of London. Furthermore, the input of the private sector had been requested through a questionnaire by G10 member states. This was also a deviation from the earlier crisis resolution period, in which negotiations with the private sector were not that formalised, and certainly not coordinated at the international level.

CACs can perform a number of functions, but most importantly they facilitate decision making in case of restructurings of the bond contract. In the case of bonds without CACs, every bondholder can decide for themselves whether to agree to a restructuring of the bond contract, creating a free-rider problem (also known as the rogue creditor problem). Although it might be best for the group of bondholders to accept a (limited) reduction in the value of their bonds instead of forcing the country into full default, each individual bondholder has an incentive not to accept the reduction of value and let other bondholders carry the burden. CACs tackle this problem by instituting majority decision making for a specific bond. If a certain percentage of bondholders agree to a restructuring (usually a supermajority), this is imposed on the whole outstanding bond. Hence there is no possibility for hold-out creditors to keep demanding full payment and so sabotage the deal. The CACs require no global level supervision, but would be a solution on the bond-issuing state level. This G10 report did not set an explicit global level standard, but was a recommendation and does therefore in my view not entail a shift in the level of governance. The CACs are a market-based solution, also in the sense that they require negotiations between the debtor state and private creditors as market actors. Although the various plans for dealing with the Latin American debt crisis assigned a cofinancing role to the private sector, they were never formally involved in the crisis resolution efforts (as they would be under the adoption of CACs). Debtor states in crisis would suddenly have to negotiate with private financial services firms on top of their ‘normal’ negotiations with the IMF. This entails a shift in governance to more private sector authority in governance mechanisms.

The 1997 G10 report was duly ignored by the private sector⁴⁸ and the bond-emitting countries. The outbreak of the East-Asian crisis around the time of publication of the report focused the attention of policy-makers on the immediate response to this crisis. This immediate response was quite similar to the response to the Latin American debt crisis: IMF-led financing combined with moral suasion of banks to roll-over loans (most notably in the South Korean case). However, the sheer magnitude of this crisis opened up the debate in the policy community, and led to an opportunity for new, radical ideas to be taken up. A large number of new initiatives and institutions was proposed by academics and practitioners (and old ideas were again put on the policy-making agenda).⁴⁹ However, even in this whirlwind of proposals, the common pro-market outlook of the policy network rapidly precluded some

⁴⁷ G10, 1997, p. 5.

⁴⁸ Helleiner, 2006, p. 15.

⁴⁹ See for a discussion Eichengreen, 1999 and Noble & Ravenhill, 2000.

ideas, such as capital controls or Tobin taxes.⁵⁰ In 2001 IMF First Deputy Manager Krueger launched a new complete proposal for a Sovereign Debt Resolution Mechanism (SDRM).⁵¹ This mechanism to simplify the resolution of sovereign debt crises by restructuring debt through an independent 'court' (comparable to national bankruptcy procedures). This proposal (even more than the CACs) addressed the situation of countries diversifying their sources of capital, and hence the increasing complexity of debt restructuring negotiations. It would cover all outstanding claims of a country and subject them to an integrated rescheduling / restructuring. This focussed the discussions in the policy-making processes on the dual tracks of CACs and SDRM, both based in an analysis of market structures and market failures / externalities. Hence, the debate in the policy community focussed on two proposed patterns of governance both having their origin in international (if not global level) public organizations. However, the debate in the policy community of course also involved the private sector, to which we turn now.

Private sector representatives responded indifferently to the proposal in the first instance. It was their view that the complexity of establishing such an SDRM would prohibit the successful implementation of the proposal.⁵² Creditor member states of the IMF responded to the proposals quite positively, which is surprising given the earlier strong rejection in the 1997 G10 report.⁵³ It seems that the sheer magnitude of the East Asian crisis, combined with the intellectual force and standing of the IMF in the policy community had changed the perspective on the SDRM of quite some policy-makers, and the IMF started further developing its proposals. At about the same time, developments on the CACs gained momentum again with the establishment of a G10 working group under the leadership of Henk Brouwer (Executive Director of the Dutch central bank) in June 2002. This group was to draft 'model' CACs. The working group held informal consultations, especially with private lawyers, before publishing its report in September 2002. The private lawyers were also expected to advise on the 'market acceptability' of the proposed CACs, meaning the degree to which financial services firms would support including CACs in international bonds.⁵⁴

With the feasibility of an actual SDRM increasing, the private sector started to respond more substantively. Led by the IIF, banking sector representatives opposed the SDRM increasingly vehemently seeing it as an unacceptable breach of creditor rights. The IIF lobbied the IMF directly, for example through its policy briefs in advance of the Fund's spring and annual meetings. While the IMF steadily reduced the global authority the SDRM would have, the private sector broadened their coalition (with associations as the Emerging Market Creditors Association coalescing with the IIF in what became known as the 'Gang of Six')

⁵⁰ Cohen, 2003.

⁵¹ Krueger, 2001. Only months earlier the US Treasury International Secretary had hinted at such a mechanism in a speech which received wide attention in the policy-community.

⁵² Confidential document source.

⁵³ Possibly the 2001 Argentinean default changed the views of policy-makers.

⁵⁴ G10, 2002, p. 2.

demanding market-based solutions (which includes CACs) to sovereign debt crises.⁵⁵ As opposed to the earlier Latin American episode, the sense of unity in opposition of the private sector was much greater. Importantly, the private sector had formed transnational business associations which lobbied directly to the public sector at various levels. Moreover, these actors often had a relatively high degree of access to the policy network (not to say they were actually part of it). An example is the IMF's Capital Markets Consultancy Group in which top level management of the IMF discusses the world economy but also its policy initiatives with high level representatives (board members) of the financial services industry.

Emerging markets, in apparent reaction to the private sector opposition, in the meantime seemed to oppose any regulation of international capital flows, for fear of increasing borrowing costs.⁵⁶ The policy-making process culminated in the September 2004 IMF Annual Meeting in Dubai.⁵⁷ Lobbying activity of the private sector in the run-up to this meeting increased in intensity, with the traditional IIF position paper being supported by visits of domestic banking executives to the Ministries of Finance and central banks at the highest level.⁵⁸ As another blow weakening the case for the SDRM, Mexico emitted the first international bond under New York law with CACs. The Mexican Minister of Finance later admitted that the main reason to include the CACs was "to get rid of the SDRM."⁵⁹ Given the opposition from all sides and the faltering support, the SDRM proposal was shelved by the IMF Board of Governors. The market-based CACs were to be the only substantial change in the governance of sovereign debt crises.

Three things stand out from the policy-making process surrounding the resolution of the Mexican and East Asian financial crises. First of all, an important part of the negotiations took part between global level actors (both private and public). With the emergence of this transnational policy network, for example NGOs, but also domestic level actors like ministries of social affairs, have been excluded from the policy decisions made. Furthermore, this development has certainly not strengthened the voice of low- and middle-income countries in determining the patterns of governance. Secondly, the members of this policy network have to a large degree a same background in economics and therefore show a common problem definition (market failure) and yardstick for solutions (improving the functioning of the financial markets). These shared values and beliefs are underscored by the prevalence of a career pattern where jobs in financial services firms are mingled with stints in the public sector (central banks, ministries of finance, and international organizations like the IMF and the BIS). Third, through a combination of excluding other actors and the shared belief system, the pattern of governance consists of market-based solutions. Representatives of the private

⁵⁵ The Gang of Six consists of the Bond Market Association, EPCA, EMTA, IPMA, IIF, and the Securities Industry Association.

⁵⁶ Informal communication with Emerging Market representative.

⁵⁷ Coincidentally, Argentina also launched its much-delayed debt restructuring plans at this summit.

⁵⁸ For example, a delegation of ABN AMRO and ING (both banks closely involved in the IIF) paid a visit to the Dutch Minister of Finance.

⁵⁹ LatinFinance, December 2003, p. 24.

sector consciously lobby against global level solutions, in the knowledge these are likely less market-driven.

4. Conclusion

This paper sought to explain changing patterns of global financial governance, with specific reference to the interaction between public and private forms of governance. Despite (or because?) several decades of financial globalisation and the immense growth of the financial system, financial crises keep occurring. Millions of people, mainly in middle-income countries suffer from periods of poverty as a consequence. The policy solutions proposed in response to the 1980s Latin American debt crisis and the late 1990s Mexican and East Asian crises were compared to seek for explanations for the changes in the territorial level and form of governance.

The response to the Latin American debt crisis seems to have been an ad-hoc, state-based resolution of the sovereign debt crises. The strategy was promoted and effectively led by the American Treasury, and did not lead to new global level rules for governing the market. In the period after the East Asian crisis, on the other hand, quickly actual proposals for new patterns of governance were elaborated in the policy network. Most pronounced of these were the SDRM proposal and the drafting of model CACs. Both entailed a shift the level of governance upwards. The eventual outcome of the policy-making proposals (model CACs), however, was a much lesser shift upward than the SDRM would have been, with the implementation and effectuation of the change in pattern of governance domestically based.

Developments in the pattern of governance in the period under analysis show a distinct shift towards more private (market-based) forms of governance. In the various responses to the Latin American debt crisis, the leading creditor states emphasized regularly the central role of the IMF, while the private sector was supposed to 'follow the lead' in a cofinancing role. However, the adoption of CACs in sovereign bond contracts gives financial services firms a position at the negotiating table as an equal partner. Moreover, distinctly public forms of governance which were given serious consideration in the policy-making process (notably the IMF's SDRM proposal) were defeated.

To turn to the central question of this paper: how can we explain these shifts in the level and form of governance? An important distinction between the Latin American and East Asian episodes is the emergence of a transnational policy network. Negotiations in the policy-making process in the aftermath of the East Asian crisis were much more driven by internationally active financial services firms and International Organizations (notably the IMF). The main policy proposals came from the IMF and the G10, both of which negotiated with the IIF and/or directly with internationally active banks on their proposals. The voices of debtor countries or other societal interests in the policy-making community were effectively shut out of the policy network. The strong representation of private sector interests at this level, combined with relatively limited democratic accountability of public sector representatives, enables them to satisfy their material interests (market-led financial

governance mechanisms). The dominance of the emerging transnational policy network is compounded by their shared values and beliefs. This ideational factor leads the members of this policy network to a common problem definition (market failures) and common standards for the solutions (improving financial market efficiency). These shared values and beliefs are nurtured by a common educational background and the frequent interaction and more importantly role-changes of the public and private actors in the policy-making community. Its operation can be witnessed in the quick dismissal of 'radical' solutions like capital controls after the East Asian crisis because it would distort market forces.

Further research is needed to establish whether the emergence of a transnational policy network in global financial governance has also affected the patterns of governance in other policy domains, for example the supervision of banks. Furthermore, and more importantly the implications of these shifts in governance for normative questions of legitimacy, accountability and most of all equity should be analysed.

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