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**GOVERNMENTS, BANKS AND GLOBAL CAPITAL**

**The Emergence of the Global Capital Market and the Politics of Its Regulation**

**Volume II : Securities Markets in Global Politics**

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## VOLUME TWO: SECURITIES MARKETS IN GLOBAL POLITICS

The previous chapters outlined the development of modern securities markets, covering their origins, functions and main participants. The rise of a truly global securities market came as a logical outcome of that development and was reinforced by other factors, external to the economic nature of the securities market itself.

As has been pointed out, one of the distinctive features of the global securities market is a high level of systemic risk. Financial market operations spanned the globe and contributed greatly to an ever-growing integration and interdependence of national economies. Nevertheless, global financial transactions had not been perceived as a potential threat to stability of the system until the 1982 debt crisis. Since then, perceptions of global linkages, international responsibilities and actions, as well as national policy, have been undergoing radical change. The evolution of conceptions concerning various economic and political issues was further supported by a number of incidents that followed the explosion of the debt-bomb. There was the 1987 stock crash and the mini-crash in 1989, as well as a number of widely publicized financial scandals. All this revealed a serious level of fragility of the global (as well as the national) financial structure.

At the same time, these incidents drew attention to numerous loop-holes and inconsistencies that exist in financial regulation. It became obvious that finance is no longer just the concern of domestic economic policy. Today's level of internationalisation of banking actually "upgraded" finance issues on the political agenda. International financial problems have increasingly come under the scope of international relations, i. e. foreign policy.

"By becoming truly international actors, banks have entered as full participants into the realm of foreign policy. High finance and high politics are now closely interdependent."<sup>1</sup>

Rising awareness of major countries that an innovative, global approach to international finance should be taken laid the ground for a new stage in international cooperation and policy formulation. Policy choice between efficiency, profit and growth, on one hand, and system soundness, control and regulation, on the other hand, was not seen any more as involving contradictory (mutually opposed) alternatives. Also, perceptions of policy formation changed in the way that new and different actors, other than the governmental ones, became parts of the policy community. The global political debate evolved to include various actors, with

different motives, goals and values that they sought to achieve. Several stakes were brought onto the agenda, covering "problems" that have been perceived as the most urgent and serious in relation to the functioning of the global securities market.

The purpose of the following chapters is to add a "political" dimension to the theoretical, economic analysis of the first part. In order to get a "full picture", the focus of the analysis has to be shifted from the theory, facts and figures, to the real world of actual banks, operating international organizations and (still) existing state boundaries. Global securities transactions do not take place in the ideal-type world of economic theory, but in the world consisting of different actors, decisions and strategies.

## **CHAPTER FOUR: WARNINGS**

Financial markets today perform a wide range of functions in the process of social reproduction. Generally speaking, the most important function is to provide the best use of accumulation. Also, financial markets have to produce information about financial assets and flows, in a way that enables adequate signals to be transmitted to market participants. In addition, the securities market, together with other financial markets, has to be one of the information sources for government, in formulation and implementation of the national macroeconomic policy. This is clearly the argument in economic theory, but in reality the "communication channels" between the market and the government are often obstructed by various barriers and time gaps. These communication obstacles sometimes originate from the collision of interests between major market participants and the government (see Chapter 3, on the origins of Eurodollars). Sometimes, different actions taken by different government departments reflect conflicting goals and strategies, and simultaneously cut across different policy domains (e.g. the support of expansion abroad can enter into a collision with certain foreign policy goals). Under other circumstances, information produced in the market can be inadequate due to a lack of regulatory and legal attention being paid to certain market elements, products or participants. Finally, governments and other market participants can be misinformed due to speculation and fraud. However, it took billions and billions of dollars in bankruptcies, non-performing loans, thefts and frauds for financial markets' signals to be taken seriously into the consideration. This chapter is therefore focused on recent, most important warnings sent out by global financial markets - warnings concerning both an underdeveloped structure (of regulation) and overdeveloped processes.

### **4.1. The debt crisis**

On August 12, 1982 Mexico announced to the world that it was no longer capable of servicing its external debt, and the suit was soon followed by Brazil and Argentina. At that time Mexico's external liabilities (official and private long-term debt, short-term debt and IMF credits) amounted to 82 billion dollars. It represented almost 11 percent of the total foreign debt outstanding for all capital-importing

developing countries. Taken together, the share of these three biggest debtors in total developing countries' debt was over one-quarter when the crisis broke in 1982.<sup>2</sup> This came as a "shock" to all creditors, although there had been signs troubles were coming earlier in the year. In February 1982, the peso was devalued by 50 percent, followed by political and economic disturbances that encouraged a major capital flight from Mexico. The Falkland crisis in April 1982 resulted, inter alia, in freezing 1 billion dollars of Argentinean assets in British banks, which in turn caused Argentina's default on debt-service payments. This also raised fears that it would declare a general debt moratorium, which could eventually spread across other Latin countries.

However, the outbreak of the crisis was seen as a potential global catastrophe, and the efforts to contain it were seen as a pure "rearrangement of the deck chairs on the Titanic".<sup>3</sup> That fear was based on the fact that the world community had never before been faced with a crisis of such a size, reach and complexity. Many commercial banks became so deeply involved in sovereign lending to developing countries that a potential default of any of the major ones would have severely endangered national financial structures and the international financial system as a whole. It was (finally) realized that the banks alone could not properly handle these problems. To the extent that potential defaults could affect domestic structures, the problem outgrew the sphere of monetary aggregates and economic relations. Perceived threats to national financial systems were not any more seen as just economic dangers, but also as political questions. They have become foreign policy concerns. The situation was particularly "delicate" for the US money centre banks, like Citicorp, Chase Manhattan, BankAmerica, etc. In 1982, the nine large money centre banks in the US had over 250 percent of their capital in loans to developing countries.<sup>4</sup>

"How could these presumably prudent institutions have made such a large number of apparently dubious loans? Much can be learned about the dynamics of international banking by examining some of the reasons why banks could have allowed themselves to become as deeply involved as they did. Explanations could also aid greatly in the framing of an appropriate public policy on international banking for the future."<sup>5</sup>

Although the origins of the debt crisis could not be solely located within the securities market, international responses to the crisis are instructive for this part of the analysis. Beforehand, it is necessary to outline the conditions under which the debt problem started to emerge.

It is generally accepted that the crisis had three basic causes. On the debtor side, it was imprudent macroeconomic management. As it has resulted from a unique interplay of economic and political factors in the developing countries, it certainly deserves more clarification.

Firstly, public expenditures were relatively high and not always directed to



the most productive uses (such as, stimulation of employment, human resource development and industrial consumption). They were also not used to smooth the imbalances resulting from extensive horizontal social migrations, neither they were used to alleviate the consequences of high population growth.

Secondly, high public expenditures were coupled with relaxed fiscal and monetary policy, contrary to the basic economics but in line with domestic political developments in some of the debtors. The latter primarily concerns the rise of authoritarian regimes and of militarism. Although it may seem contradictory at first, relaxed fiscal and monetary policy were actually pursued at times of high military expenditures. Low taxes and easy access to the credit market were definitely effective ways to acquire public support and legitimation, at least in the short run.

Thirdly, the heavy burden of public expenditures also originated from oversized, inefficient bureaucratic machineries. These were less often used to carry out macroeconomic policy, but were instead indispensable channels for political bargaining, bribery and corruption.

Fourthly, even in the countries which were developing a sort of long-term industrial policy (mostly larger Latin American debtors), import-substitution industrialization was by far more popular than the promotion of export. It is accepted that the first approach to industrialization requires a longer period and a constant inflow of financial and technological resources. However, excessive borrowing that was practised by a great number of developing countries was just seldom used to support long-term industrialization. Far more often, inflow of foreign capital was directed to military expenditures.

Fifthly, there was the problem of "capital flight" which incorporates many of economic and political features of developing countries. While governments were heavily borrowing abroad, private investors from the same countries were acquiring foreign assets at a substantial rate. Capital flight is usually described as

"... short-term outflows for speculative purposes or outflows resulting from economic or political uncertainties in the home country. In other words, it is money 'fleeing' from the country rather than external investment guided by long-term economic consideration."<sup>6</sup>

Due to different criteria used to quantify the extent of capital flight, estimates of its importance vary. In 1982, the ratio of cumulated capital flight to total external debt was between 15 and 30 percent.<sup>7</sup> To put it simply, for every one dollar of credit that had been lent, between 15 and 30 cents "flew" out. Capital flight occurs most often in developing countries with relatively free payments systems, overvalued currencies, highly controlled interest rate and growing fiscal deficit. All this is combined with a relatively larger perceived investment risk, resulting from underelaborated legislative arrangements (e.g. inadequate private property protection, possibilities of expropriation, etc.) and the instability of political and economic conditions. The advent of capital flight from developing countries have not just

diminished the availability of funds in the country, but have also affected the attitude of creditors. They have become less willing to finance future capital flight.

The advent of the debt crisis is most often analyzed from the economic perspective, treating the political performance of Third World governments as a residual rather than an explicit variable. L. Snider has offered a model for assessing the relation between the political capacity of developing countries' governments and the probability of debt service suspensions.<sup>8</sup> The concept of political capacity takes two dimensions in evaluating government performance: 1) a government's ability to penetrate society and exercise effective authority, and 2) a government's ability to extract human and material resources to support its objectives.<sup>9</sup> Snider develops the concept further and adds two other variables: the existence of capital flight and the foreign creditors' judgement about the government's ability to manage economy. So, the political capacity of a country will be higher if: a) the government carries out prudent fiscal management, b) the level of local investors' confidence in the government's ability to manage the country's political and economic problems is high (i.e. if there is little capital flight), and c) the government is perceived as manipulating macroeconomic policy for structural adjustment, rather than for accommodating the demands of local political groups. The higher the political capacity, the lower the probability that the country would enter serious debt-servicing problems and suspend debt-service payments. Snider concludes that

"the developing countries' suspension of payments on their external debt is as much a consequence of the political weakness of their governments and the excessive politicization of their economic policies as it is a result of unfavourable structural changes in the international economy."<sup>10</sup>

On the creditor side, the debt crisis was caused by imprudent lending of by commercial banks. The attribute "imprudent" relates primarily to their lending over-exposure in relation to capital and short-term strategy of profit maximization. The "over-stretching" was nothing new to commercial banks, but the extent of that was largely precedential. A highly profitable lending to sovereign clients was seen as an opportunity that had to be used immediately and intensively. Furthermore, loan-loss reserves were very low because of the wide-held illusion that sovereign borrowers could not go bankrupt. Low reserves could be also interpreted from the aspect of inadequate rating of potential borrowers' creditworthiness, due to the banks' own incapacibilities and due to somewhat misleading financial information given by borrowers themselves. Imprudent lending also concerned declining spreads on loans, due to a fierce competition between the banks for sovereign clients (see Table 1, page 9). Finally, there was a general economic and political context that encouraged these developments. The abundant supply of funds (petro-dollars) logically flew into already internationalized commercial banks. Rising demand for capital, on part of the oil-importing developing countries, could easily be met through commercial banks' strategies that relied on the turnover increase and swift profit seizing. Real

interest rates during the seventies were exceptionally low and for a few years were even negative (lower than the rate of inflation) and the interest was fixed.

"It will be recalled that the 1976-1979 period was characterized by largely unanticipated worldwide inflation; until at least 1978, most lending was at fixed interest rates, and the resultant ex post real rate of interest was negative."<sup>11</sup>

Under these conditions, the borrowing became increasingly attractive. Having in mind the experience of lending to East European countries, creditworthiness of potential borrowers seemed promising. In the 1970s, commercial banks took over the leading role in creation of international liquidity for balance-of-payments purposes.

"Medium and long-term international bank commitments totalled some 225 billion dollars in 1976-82. In 1982 alone, such commitments amounted to 42 billion dollars, with Latin American borrowers accounting for 23 billion."<sup>12</sup>

Moreover, there was a range of widespread misconceptions concerning the lending to developing countries. At least until 1979, the shift from official to private flows had been seen as a "healthy" development that underscored flexible and efficient functioning of financial markets. Besides, the recycling was regarded as an efficient allocation of world accumulation. Capital flows were thought to be self-financing, due to high, expected, real rates of return on investments in the borrower countries. Furthermore, capital injections would greatly contribute to the development of market economies in recipient countries, this way improving their integration into the world economy. It was widely held that countries cannot go bankrupt, cannot fail to exist, so the inherent lending risk is not of a substantial height. In addition, it was thought that borrowers would not deliberately enter into default, for it would hurt only themselves and shut them out from the world financial markets. Another popular misconception at that time was related to banking strategic policy: any risk in international banking was considered as being safely limited through geographical diversification and shortening of maturities. So, the banks were already on the global scene when lucrative opportunities opened up and they were able (allowed) to use them extensively.

The shift in worldwide economic conditions in 1979-1980 was dramatic: the worldwide inflation accelerated (in mid-1980, the G-7 average inflation rate was over 12 percent!), oil-importing countries' current account swung sharply negative, and the recession set in.<sup>13</sup> Most importantly, there was a change in the policy of industrialized countries. Anti-inflationary action became the highest priority, monetary policy tightened and interest rates rose to over 15 percent in 1982. Worldwide recession and rising protectionism in the industrialized world caused a reduction in developing countries' exports and seriously lowered their growth rates. The balance-of-payment crisis in the developing countries was inevitable. Their current-account deficits rose from about 30 billion dollars in 1978 to over 100

billion dollars in 1982. The outstanding long-term debt rose from 360 billion dollars (1979) to 552 billion dollars (1982).<sup>14</sup> As their export earnings were falling and the interest rates were rising, the burden of the debt became too heavy. The following table summarizes main features of the debt crisis.

Table 1: THE DEBT BURDEN 1979-1989

	1979	1982	1984	1986	1989
Total outstanding long-term debt (billions of US\$)	359	551	673	753	1000
Spontaneous lending as % of total financing *	na	88%	42%	49%	61%
Average spreads (in % over LIBOR)					
-developing c.	0.9	1.1	1.3	0.6	0.7
-industrialized c.	0.7	0.6	0.6	0.4	0.4
Average maturities (in years)					
-developing c.	8.5	6.8	7.0	8.1	8.0
-industrialized c.	9.0	8.3	8.5	6.3	5.9
Total debt/exports ratio (in %)	110	152.4	157.9	194.9	146.5
Ratio of debt service to GNP (in %)	na	4.6	4.9	5.5	na
Restructured debt (billions of US \$)	-	-	105	60.5	52
Debt conversions (billions of US \$) **	-	-	0.7	1.6	5.8

\* Total financing includes all cross-border commercial bank claims on developing countries: facilities, spontaneous lending, concerted lending and bonds.

\*\* Face value of debt converted under various schemes, but not including cash buy-backs and debt exchanges.

(Sources: IMF [April 1990]: "International Capital Markets", UNITED NATIONS, Department of International Economic and Social Affairs: "World Economic Survey 1990")

What is of great interest for the course of the study is the evolution of responses to the debt crisis. It is held that the debt-crisis management passed through several phases. It seems this path greatly resembles changes in perceptions about actors responsible for the crisis management, as well as about ways and means to carry it out.

In the first phase, in 1982-1983, commercial banks assembled short-term emergency packages because it was thought that liquidity problems were temporary.

Loan maturities were prolonged and new financing disbursed, at spreads of over 2 percent above LIBOR.

The second phase was in 1984-85, during which debtor countries took time to prepare and implement required reforms, and creditor banks engaged in building capital and reserves. It was the period when certain important changes were introduced. Multiyear rescheduling agreements (MYRAs) replaced single-year rescheduling. Longer grace periods were allowed, and longer maturities agreed upon. It was also the period when the spreads over LIBOR were very low (1 to 2 percent). Most importantly, there was a significant change in perception of the problem: it was not seen any more as a temporary liquidity problem, but rather as a longer-term solvency problem.

The third phase began with the IMF/World Bank meeting in October 1985, when the so-called "Baker Plan" was announced. Growth-oriented structural reforms in debtor countries were emphasized, as well as the need for the banks' home countries to become involved in the crisis management. The planned target of 20 billion dollars in new financing by the US banks was never achieved, but it became clear that without additional capital inflows debtors would not be able to carry out reforms. Another multilateral financial agency, the World Bank, was brought into the fray.

"It was suggested that annual disbursement from the World Bank and the Inter-American Development Bank to principal debtor countries should, over the period 1986-88, rise by about 50 percent from the projected rate of 6 billion dollars a year."<sup>15</sup>

The role of the World Bank should also be enhanced by the operations of both the Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation. These operations would assist in attracting non-debt-creating capital flows to developing countries. It was realized that the adjustment (reforms) and growth should reinforce, not conflict, each other. By the same token, more cooperation was needed between the US government, the international lending institutions and the banks.

Another important development in the perception of the crisis management occurred in this phase. It was recognized that a substantial portion of the responsibility rests upon the industrialized countries. Enlargement of the "economic pie", through economic growth, involves

"... not only a concerted effort by the debtor countries to increase their exports, but also continued access to markets in the industrialized countries.

This latter condition is absolutely essential..."<sup>16</sup>

In other words, the misconception regarding the functioning of the world economy (as consisting of separated national economies) was brought to an end. It was finally realized that, besides enhanced multilateral action and improved macro-economic management in the developing countries, the management of the debt crisis required

new forms of international cooperation. This implies coordination in a way that would enable countries to take full account of the international repercussions of their own policies (mostly fiscal and monetary policy).

During the fourth phase, the crisis management relied on an increased role of the market and the list of restructuring options has been substantially expanded. It was necessary for the banks to write down the balance sheet (face) value of the loans in order to rationalize their portfolios. Operations on the secondary market initially took form of loan swaps and cash buy-backs (the retirement of debt at a discount through a cash prepayment). Available indicators point to steady growth of the market: from an average turnover of 5 billion dollars (1985-86), it rose to around 30-40 billion dollars in 1988. However, secondary market prices fell from around 70 percent of the face value in 1986, to around 30-35 percent in 1990.<sup>17</sup>

During the fifth phase debt conversions became an ever important component, and initially included a change in the nature of the claims: debt-equity swaps and exit bonds.<sup>18</sup> Management options later included cofinancing facilities with the World Bank and trade financing facilities. The application of the broadened menu of options has been facilitated by, and contributed to, the expansion of the secondary market for the developing countries' debt.

Other types of debt conversion have also attracted interest of both creditors and borrowers. For example, debt-for-exports transactions involve the exchange of claims for local currency that is then used for the settlement of payments to exporters in the debtor country. Debt-for-nature swaps imply that the debt is bought, at a discount, by conservation organizations and later converted into local funds for environmental protection. Debt-for-good-causes operations rely on the creditor bank's donation of claims to charitable organizations which will use them in the debtor country.

This phase in the crisis management came with a wide-spread recognition that voluntary debt-reduction and new financing are not mutually exclusive, and that creditor banks should greatly enhance their defensive strategies (loan-loss provisions). In March 1989, the so-called "Brady Plan" was announced. The proposed voluntary debt-reduction should be accompanied by additional commercial banks' financing, and by the support debt-reduction programmes provided by the World Bank and other institutions. Of course, this was aimed to solve (to ease) debt problems of developing countries which had prepared viable (acceptable) economic reforms. The 1990 package for Mexico included almost all of the developed techniques and instruments for the debt management.<sup>19</sup>

The debt-management techniques were accompanied by a reduction in exposure of large commercial banks. The US banks were the most "enthusiastic" in this sense: their total claims on the developing countries were reduced from 145 billion dollars in 1983, to 85 billion in 1989. During the same time, bank capital was gradually built up and the ratio of their external claims to total assets was

lowered by almost 50 percent.<sup>20</sup> This balance-sheet improvement recorded by large commercial banks was not just the choice of their changed strategy, but it came more as a result of government pressures imposed on them in order to prevent systemic failure. The so-called "public umbrella" to cover over-exposed banks, or precisely the safety net which should prevent large-scale bank failures, proved to be neither cheap nor easy to open. Governments agreed to back-up the debt-management arrangements, but under the condition that banks strengthen their capital base and provide additional (although limited) new financing. On part of the banks, their strategic policy was aimed to correct the "disaster myopia"<sup>21</sup> that characterized their attitude towards lending to the developing countries in the 1970s and in the beginning of the 1980s. After 1982, a more cautious and defensive approach was taken, so that new financing to developing countries almost disappeared. This was exactly the reason why the Baker plan failed.

Since mid-1989, some developing countries (mainly Latin American ones) have regained access to voluntary sources of private capital. This took the form of international bond issues on the main capital markets, of trade and project financing and short-term interbank facilities. These flows were mostly encouraged by substantial privatization programmes in Latin America. However, the large syndicated bank credits did not resurface.

On the side of the official financing (developing countries' debt to governments and officially guaranteed export credits), the Paris Club actions have to be mentioned. The Paris Club is a multilateral forum created for the purpose of assisting the developing countries in rescheduling their debt to foreign governments. This assistance was traditionally related to temporary international liquidity problems, but later was extended to more substantial debt restructuring. Some actions of the Paris Club in 1988 ("Toronto Terms") and 1990 ("Trinidad Terms", implemented unilaterally by the UK and Canada) clearly demonstrated that the creditor governments had accepted the fact that a more flexible and longer-term approach was necessary. This included more substantial debt-cancellations and restructuring on concessional terms (longer maturities, longer grace periods, lower interest rates, etc.). The actions aimed at more extensive debt relief were taken almost simultaneously by the G-7 at the 1991 London summit, and by the IMF and the World Bank at their 1991 Bangkok meeting. It was concluded that a more extensive debt relief was needed, particularly for low-income countries. More important, some arrangements of the Paris Club with Nicaragua and Benin (in 1991), as well as with Bolivia and Tanzania (in 1992) included a "good will" clause. Under that term, the Paris Club agreed to consider further debt relief after the consolidation period, and committed itself to reconsider the debt problem in three to four-years time. It was concluded that the debt strategy should be strengthened by expanding the number of support channels. This should include the provision of new financing, various forms of debt restructuring and aid on highly concessional

terms.<sup>22</sup>

So, the evolution of the debt strategy underscores several points that have been taken in consideration. Alongside with the development of financial techniques for debt relief, it was realized that the strategy should be a long-term and comprehensive one. The main causes of the crisis are of a structural, not temporary, nature. These structural imbalances concern not only economies of the developing countries, but also the world economy as a whole. It was a threat to the stability of the global financial system that pointed out a high level of world economic integration. For that reason, responses to the crisis should rely on new forms of multilateral action. The debt crisis management should involve different kinds of participants: governmental actors (from both creditor and debtor countries), private financial institutions (commercial and investment banks, institutional investors), international governmental actors (G-7, IMF, the World Bank, the Paris Club, the Non-aligned Movement, the Organization of African Unity, etc.) and international non-governmental actors (e.g. professional financial associations, conservation organizations, charitable organizations).

It was perceived that the approach to the problem should focus more on economic conditions and performances. It has to be more linked to the real economy and not limited within the "financial world". This shift is already evident in the scope of restructuring options. Several menus include debt-conversion schemes which are based on economic performances of the debtor country, such as debt-for-exports swaps, value-recovery clause, etc. Also, the improvement of the economic environment requires certain actions of the creditor countries (dismantling protectionist barriers, government loan guarantees, etc.). Creditors have realized that the global approach must not bring adjustment efforts and the economic growth of the debtor countries into a collision. This demonstrates that a closer collaboration between commercial banks and debtors, on the one hand, and the international financial organizations, on the other, is a necessity.

Responses to the debt crisis also emphasise that a new approach towards financial markets is essential if some of the causes are to be eliminated. Some of the basic financial market functions have to be re-examined, from the aspect of both national and international regulation. This primarily concerns the allocative function of the market, i. e. to what degree financial markets should be autonomous in order to provide the best allocation of accumulation. In addition to that, the informative function of the market has to be used for controlling the level of systemic risk. Also, it has to be analyzed what forms and modalities of regulation are complementary to the global level of financial market functioning. A new approach should take into account the changing nature of the role of government in balancing different "national" interests and goals. Financial links created the underlying structure of global interdependence wherein almost each and every issue cuts across finance. "High finance" outgrew the limits of so-called low politics (economic and



social issues) and increasingly became the auspices of "high politics" (in this case foreign policy). This clearly demonstrated how demarcation lines between different policies are becoming more and more blurred. Under these conditions, the government should rely more on active communications with the banking (financial) community, but also on improved contacts within the community itself. A new approach should not seek to over-regulate the market, because many historical examples deny the efficiency of stringent regulation in banking. Artificial functional or geographical barriers, contradictory to fundamental business motives, have often been overcome with more or less difficulties. The purpose of a new regulatory approach should be to allow "entrepreneurship" in banking, but at the same time it should condition the safety of the public umbrella with a sound and prudent banking policy. Namely, banks should be safe within the national financial system but the price that has to be paid is an improved capital base, adequate information disclosure and a vigilant lending policy.

The debt crisis management is the most illustrative example of how the world community (more precisely, major industrialized countries) responded to the global financial threat. On the whole, the actions taken from 1982 to 1989 can be described as a continual interplay of various actors and of various goals. In the first and the second phase, main actors included debtor countries' governments and the IMF. The third phase was marked by the US government initiative, after a more active approach was taken by a great number of developing countries. The latter was certainly a new development, concerning a very limited number of actors participating in the previous phases. A wider scope of the debt-crisis politicisation underscored a number of dimensions from which the problem could be analyzed.

The period from October 1987 to March 1988 saw a number of initiatives, conferences and summit meetings, all concerned with the debt crisis. The IMF introduced the enhanced structural adjustment facility (ESAF) in October 1987. The Commonwealth meeting in Vancouver, in October 1987, welcomed ODA-debt write-offs by Canada for African Commonwealth countries. In December 1987, The Paris Club agreed to provide new, fresh aid to low-income African countries. Brazil, Argentina and Mexico formed the "Group of Three" in September 1987. A summit meeting of eight Latin American debtor countries was held in November 1987, in order to discuss possibilities of a joint response to the US banks. The Organization of African Unity (OAU) held a special conference on African indebtedness in November 1987. Following the 1987 Harare summit of the Non-aligned Movement, the South-South Commission was set up to facilitate cooperation between debtor countries themselves. These were just few among many other activities initiated by debtor countries.<sup>23</sup> However, this phase is significant for the course of this study as it clearly points out a diversity of channels in international relations.

The fourth phase in crisis management featured an intensification of banks'

initiatives. Finally, in the fifth phase, the US government initiative involved creditor banks, international institutions and debtor countries governments. The final phase also underscored a shift in perception of the debt crisis: it was not seen (and dealt with) just as an economic threat, but as a political threat as well. The latter dimension was particularly emphasized by the need for "delicate" balancing between two overreaching aims: systemic efficiency and systemic stability. An episode that is described in the following section provides another dimension to this efficiency-stability balancing.

#### **4.2. The 1987 stock market crash**

Ever since the Wall Street collapse in October 1929, both financial market regulators and participants have been aware of the danger involved in a sudden market collapse. However, as the decades were passing, the lessons from that turbulent period were put more and more behind. The so-called disaster myopia (already mentioned in the former section) was progressively developing, enforced by every major economic upswing. Then, suddenly, within just four working days, general perceptions of the global financial structure was enriched by a new and dramatic experience. This does not imply that financial fundamentals (operations, participants, strategies) underwent radical changes, but since October 1987 many beliefs concerning the securities market have been altered.

It is generally accepted that the 1987 Crash happened on the Black Monday, October 19th. During that Monday and the next day, the Dow Jones Industrial Average (DJIA) collapsed over 22 percent, or 508 points. Just for the comparison, on October 28th, 1929, Dow Jones declined almost 13 percent. Another indicator, Standard & Poor's 500 share index, declined almost 20 percent on October 19th 1987. The FT-SE in London was down 12.2 percent, the DAX index in Germany went down 7.1 percent, and all other major markets were seriously affected. The Honk Kong market was down almost 35 percent, which induced its closure. The Australian market received the hardest hit: a 44.7 percentage decline.<sup>24</sup> According to some estimates, the crash wiped out almost 1 trillion dollars of financial wealth in the US. It drastically lowered the volume and frequency of share-related activities on all the main markets, including the Euromarket as well. Major national markets experienced decline to various degrees (see graph 1 in the second chapter). The value of new issues of Euroequities, for example, went down almost 60 percent in 1988 comparing to 1987.

Although it was the first financial shock with a global reach, the 1987 crash occurred under very different economic conditions in major countries. Table 2 makes a comparison of the conditions prevailing in the crash. As evident, the crash

occurred under very different national circumstances, which could suggest that the breakdown had very little to do with economic fundamentals of the countries concerned and of the world economy as a whole. This was the conclusion about causes of the crash officially expressed in the US.<sup>25</sup> As the analysis will point out, exactly these indicators could serve to reach a completely different conclusion about the causes of the crash.

Table 2: OCTOBER 1987 - underlying economic conditions

	US	Japan	Germany	UK
October price decline (in percent)	22.6	7.5	17.7	21.7
Price/earnings ratio	18.9	61.7	15.4	16.0
Long-term gov. interest rate	9.42	4.44	6.20	9.92
Inflation rate	4.1	0.2	0.6	4.0
Current account (in billions of \$)	-143	87	45.5	-6.4
Current balance (percent of GNP)	3.3	4.4.	5.8	0.1
Net household savings (percent of income)	5.4	16.8	12.5	4.2
Business profitability (profit as % of capital stock)	22.6	21.6	17.5	13.2

(Sources: Morgan Stanley International Statistics; IMF: "International Capital Markets", UN: "World Economic Outlook 1990")

If the 1987 collapse is placed within a broader economic and political context, a different view of the crash can be obtained. In the period from 1982 to the mid-1987, investment in American stocks was gaining in attractiveness. The US corporations were praised as highly innovative and profitable. The price/earnings ratio of their shares was among the highest in the industrialized world, excluding Japan. The level of long-term interest rates offered on T-bonds was in decline from 1984 to the crash, and this circumstance further improved the attractiveness of shares. For factors affecting prices of securities see the second section of the second chapter. In the period 1982-1987, the Standard and Poor's 500 share index rose from about 130 to 280. Institutional investors came to dominate the US stock market, in terms of stock-ownership and share trading. The most widely taken investment strategy became stock-index trading: computerized programmes followed the general "mood" of the market. If the prices were falling, there was a sell order,

and vice versa. This strategy relied on a highly sophisticated technological infrastructure, which could (it had been assumed) process large orders in a minimal time.

In the case of the US, the analysis must encompass its international position at that time. The current-account deficit was rising and the saving rate was falling far below the investment rate. What was actually happening was the reversal of net international capital flows: the US became the largest net recipient of funds.

"For the most of the 1980s the depth and liquidity of US financial markets acted as a powerful magnet for foreign capital... US accounted for almost one-quarter of the rest of the world's private foreign assets towards the end of the decade, compared with little more than one-eighth at the beginning."<sup>26</sup>

Foreign acquisitions in the US averaged 12.3 billion dollars annually in the first half of the 1980; in the second half they rose to over 41 billion annually.<sup>27</sup>

In relation to exchange rates, it has to be mentioned that the dollar was overvalued throughout the period and the appreciation certainly contributed to the increase in the US deficit. The dollar started to lose its value rapidly from February 1985, and during the two-year period (January 1986 to December 1987) it lost almost 35 percent of its value against the Deutsche mark and the yen.<sup>28</sup> In comparison to the average 1980 level (1980: 100), the effective exchange rate of the dollar declined from 124 (beginning of 1986) to 92 (last quarter of 1987).<sup>29</sup>

Market fever reached the highest level in the mid-August 1987: the DJIA was around 2700 points. After that came a 50-day period of market oscillations occurring every day, but that was not taken as something serious. The crash was actually set in motion on October 14th. At 13.30 GMT, the information on the US trade deficit of 15.7 billion dollars for August was released. Fears among international investors about the actual strength of the US economy culminated with the release of the information.

"In particular, concern was expressed about the apparent unwillingness of the administration of President Reagan to take decisive action over the mounting US budget deficit, whose expansion in recent years had started to deter private investors and had thus depressed the value of the US dollar... notwithstanding the maintenance of relatively high bank interest rates, a factor which would normally have counterbalanced these uncertainties."<sup>30</sup>

This was the trigger that activated global arbitrage mechanisms and a series of chain reactions followed.

Already during that summer, there were rising concerns that the American deficit would not shrink and that eventual restrictive measures implemented by the US Government could severely damage relations in the triangle (US, Japan and Germany). On the last working day before the Black Monday, it was clear that many investors were taking defensive strategies as the market volatility had increased. Nervousness was spreading, together with rumours about the NYSE

closing down, and volatility of the market was further amplified by portfolio-insurance techniques (stock index trading). Suddenly, a wide-spread belief that the market was overvalued pushed investors to sell large blocks of shares. The market was closed down on Friday, October 16th, with an overhang of unfilled sell orders going into Monday. The performance of the market further deteriorated because a number of delayed openings on Monday had created uncertainties among investors. A trade delay in the market arises when a specialist faces an imbalance of buy and sell orders that he cannot resolve without a trading halt. During that period, he displays price indications in an attempt to reduce the imbalance. Many NYSE specialists overestimated the opening prices on Monday, and as the prices were constantly changing, investors could not know at what level their "at market" orders would be executed. As the sell orders were executed (a part of was bought by the specialists themselves and by certain aggressive trading-oriented institutions), the computer programmes of other investors then triggered further sales causing further decline. This in turn generated other sell orders and the market experienced the computer-driven "meltdown".

One particular financial development has to be mentioned here. At the beginning of the 1980s, stock index futures contracts were created, linking effectively the NYSE and the Chicago Mercantile Exchange (CME). In this way, large institutional investors could hedge their portfolios (of common stocks listed on NYSE) by trading in stock index futures contracts listed on CME. The rules governing this kind of operation require a margin to be set, i.e. the percentage of the market value of securities a customer can purchase with the use of credit. In 1974, the Federal Reserve Board set the margin at 50 percent. In contrast, in commodities and futures markets, a margin is partial surety that a contract will be fulfilled. The margin requirement may necessitate further payments by the client if prices move against him. Accordingly, a margin call is a requirement for an increase in the original deposit, placed on a contract, when: 1) the buyer has increased the size of the contract, or 2) when market prices have become heavily adverse.<sup>31</sup> So, a decrease in S&P's stock index futures on Monday triggered the chain of margin calls. The CME clearing house (which administers margin calls and settlement procedure) made margin calls on 13 brokerage firms to raise 1.5 billion dollars. When the market opened on Tuesday, brokerage firms extended credit on behalf of customers to meet these calls. But the clearing and settlement process was running several hours behind schedule. So, brokerage firms were in a huge deficit and they turned to money-centre banks for additional loans. As the banks were reluctant to expand loans, the Federal Reserve Board intervened and the position of brokerage firms were "covered". On Tuesday, October 20th, the clearing and settlement system was on the brink of a collapse that would endanger the whole financial structure.

So, it was not just the loss of value that marked the Black Monday as the

crash. It was more the danger of a systemic collapse due to an inefficient (disorganized) infrastructure, i.e. the inability of the clearing and settlement system to "follow" the depth and volatility of the market.

Five years after the crash analysts did not come to agree on its causes.<sup>32</sup> Some of them underscore the speculative role of the specialists, others put blame on the "madness of the herd" (referring to the panic among investors) or the absence of any economic leadership (referring to the Administration's neglect of the trade deficit). Some analysts point to an overdevelopment of financial techniques (e.g. computer-driven portfolio-insurance) and yet others to the malfunctioning of the market itself (see the efficiency market hypothesis, in the second chapter). However, each of the causes had its "part" in provoking the crash, but they must not be perceived as alternative reasons. Each of them was being fed by the others and only their cumulative effect can serve as a logical explanation of the collapse. The Task Force Report summarized it as follows:

"Trading under these circumstances has three unfortunate economic consequences. First, investors cannot know with any precision at what prices their orders will be executed. Second, the information conveyed by prices may be confusing or actively misleading. Third, the absence of reliable price data worsens uncertainties and can lead to unnecessarily large reductions in the credit, without which market-making activities must be curtailed."<sup>33</sup>

Regardless of different explanations of the causes of the crash, October 1987 came as a striking and unpleasant surprise to all market participants and regulators as well. It was a sudden and unexpected shock, for it occurred in the period when all major stock markets were in expansion. The DJIA had recorded an uninterrupted rise over the previous five-year period.

It was a shock because it hit the most "representative" segment of the securities market - the stock market. The market for shares, it was thought, produces the most reliable / adequate information about the state of economy and its prospects. It was found out, in a very dramatic way, that signals from the market can often be insufficient, confusing or they can come just too late.

It was a shock because it spread swiftly across major stock markets, due to a high level of market internationalization and global integration. It had been thought that the high level of financial diversification (different market segments, different national markets, different instruments) was actually reducing the market risk and hence the overall level of systemic risk. In addition, the increasing globalisation of securities transactions had been considered as beneficial: the best allocation of surplus funds must not be bounded by geographical frontiers. Computerization of securities transactions was seen as a great achievement that is cost- and time-saving. So, these features of the global securities system, highly praised in times of a "bull" market, turned against the system itself.

The 1987 crash sent out several important messages concerning the nature

and functions of the securities market. Firstly, it should be born in mind that the financial mechanism, and particularly the securities market, is highly sensitive both to its economic and political environment. The stock market in October 1987 had accumulated a substantial amount of national (American) and international economic imbalances. This precisely exemplifies the market function of shock-absorbing, but it cannot be performed for an extensively long period of time. The critical moment in October 1987 was actually the market absorption of the political news. As it became evident that major countries had not come to a consensus how to resolve the US deficit-problem, arbitrage mechanisms (capital outflows from the US securities market, both to other currencies and other securities) triggered the market collapse.

Secondly, the crash pointed out to what extent a lack of communication and cooperation between major market participants, including the regulators as well, could induce a series of chain reactions on the market. It also emphasised that those reactions were almost impossible to control, on both a national and a global level. In the words of a "Business Week" commentator, the US had evolved into the "casino society":

"The casino society is the offspring of two parents - Washington and Wall Street - who perennially misunderstand how the other works. Their miscalculations helped lay the groundwork for the Crash of 87."<sup>34</sup>

Thirdly, it became clear that although financial markets have "a life of their own", their link to the real economy must not be underestimated. Moreover, the crash clearly highlighted a significant level of overall (economic, trade, financial) interdependence. The course of the event could have probably been different, if there had not been the over valued dollar, low savings and the import of capital to the US. All this could certainly not have been "achieved" without the abundance of capital in Japan and Germany, and this yet could not have been attained without their economic upswing which has been "supported" by deficit financing in the US, etc.

Fourthly, the crash emphasized the importance of the development of an adequate infrastructure for market operations. In this case the attention was focused on clearing and settlement mechanisms.

Finally, it became apparent that the strategy "let the markets alone" could not be applied any more. In a number of countries market safeguards have been imposed in order to reduce the degree of risk stemming from erratic market fluctuations. In the US, "circuit breakers" were approved, to interrupt trading in stocks in the event of sharp market swings. All trading stops for one-half hour on the NYSE, if the DJIA falls by 250 points, or it stops for two hours, if there is a fall of 400 points. If the S&P 500 futures contract falls by 12 percent, all trading can only take place at a limit price or above, for one-half hour. In addition, another type of safeguard was developed, to limit the use of certain computer-driven trading strategies. However, it is argued that the efficiency of these measures depends on

the level of coordination between markets. If the circuit-breakers are not used in coordination, they will not halt trading simultaneously on all markets. In that case, uncertainty, about expected decline in equity prices, might increase and generate cross-market selling pressures, thus making the situation even worse.

Finally, the crash drew attention also to a number of political questions, usually left aside by the economic analysis. The most important of them concerns the applicability of the Reagan-model in many industrialized countries. This strategy of deregulation, tax cuts, less intervention and permissive deficit spending came under a serious re-thinking and criticism. The Thatcher-model of macro economics, mostly resembling the US one but adding further reliance on the financial-sector growth, have also been questioned. Accordingly, the crash came to threaten one of the significant political shifts of the 1980s - the privatization of state industries. This was particularly the case in the UK, Japan, France and Germany, where the large-scale privatization programmes were endangered by the global market collapse.

Another important political question raised by the crash tackled the relations between major industrialized countries, especially the modes and purposes of policy-coordination and collaboration in general. On the one hand, post-crash fall of the dollar was heavily undermining the Louvre Accord. On the other hand, actions agreed by the US creditors to prevent a serious dollar fall became significantly conditioned by the US trade policy. If Congress would persist on protectionist trade measures, the Louvre-agreed interventions to save the dollar would be "reconsidered" by Japan and Germany. The situation was complicated even more because the US government could not carry out the policy towards deficit reducing without the collaboration of the US creditors. Namely, a deficit cut could not be achieved without the production expansion. The growth of production, and exports eventually, required lowering of the interest rate and a devaluation of the dollar. However, this could not be realised if Japan and Germany were not willing: 1) to allow the dollar to drop, and 2) to "fortify" their commitments to promote a greater growth. So, actions on both sides became increasingly interdependent and subjected to the top-level bargaining.

Another important political question was raised in relation to the nature of economic leadership in the US. It was not just the "competition" between the White House and Congress (for example, between the House Ways and Means Committee and the Senate Finance Committee). It was also the intra-bureaucratic struggle between different government departments and agencies (for example, the Treasury, the FED, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the General Accounting Office, etc). This competition resulted in fierce debates over questions of responsibility for the regulation of financial markets. Inadequate communication and cooperation between these bodies had definitely contributed to an erosion of confidence in the US economic leadership, both at home and abroad. It became evident that the (Republican) Government was



neither speaking "with one voice", nor it could send reliable signals to domestic and foreign investors due a continuing "battle" with (Democratic) Congress.

As the crash underscored, the US debt-financing and a "living beyond means" had to come to an end. However, the conclusion of this credit era did not involve only a reduction in standard of living and a slower per capita income growth. The pressures to reduce the deficit put forward the sensitive question of cutting defence spending, with its inevitable effects on the position of the US as the military hegemon.

A huge amount of wealth was lost during those days in October 1987, but there was at least one indisputably positive outcome. The global securities market has attracted an ever-growing share of attention. The market exploded due to both internal and external disturbing forces. However, a special analytical weight attached to the 1987 crash originates not merely from the extent of the DJIA decline, but far more from the issue-linkages that became ever-explicit. The issues such as macro economic management, trade patterns, exchange rates, financial techniques, military spending, and international cooperation, were all impinged upon when the DJIA fell 508 points on Bloody Monday in October 1987.

### **4.3. The Banco Ambrosiano and BCCI affairs**

The Bank of Credit and Commerce International (BCCI) closure on July 5, 1991 represented the beginning of a world-wide affair on a scale never witnessed before. The BCCI collapse was the world's biggest banking failure, concerning not just the amount of losses invoked but also the number of countries, organizations and individuals involved. The reaction to this scandal has been evolving as a truly international one, bringing together regulators, banks and investors from a number of countries. Though this was a much-publicized scandal, it was definitely neither the first nor the only banking scandal to point to numerous regulatory loopholes and to a variety of "non-banking" activities pursued by some international banks. Therefore, the failure of another bank, Banco Ambrosiano, will be used as a brief introduction to this aspect of modern finance.

In July 1982, Banco Ambrosiano collapsed, incurring losses of about 1,2 billion dollars and affecting the group of 119 foreign banks.<sup>35</sup> Banco Ambrosiano was founded before the Second World War, and in the late 1940s it hired the enigmatic Roberto Calvi. He worked his way up to become president in the mid-1970s, when he bought himself control over the bank. By that time Banco Ambrosiano had already been described as the

"... cornerstone of the most powerful banking and financial group in private hands in Italy, and a baffling mixture of orthodox banking success and

unorthodox associations of scandals."<sup>36</sup>

Due to its long-held and extensive links with the Vatican bank, l'Istituto per le Opere di Religione (IOR), it became known as the priests' bank. One of the most "active" parts of Banco Ambrosiano was its Luxembourg subsidiary (a non-bank, holding company), which used to borrow on the Euromarkets to meet the needs of other Ambrosiano foreign subsidiaries in Lima and Managua. The IOR has always been particularly well placed at international financial markets because it is a unique institution: it is an "institutional compromise" between a bank and a trust fund. In addition, as it is subject solely to Vatican jurisdiction (as it has no branch or representative office in any country), the IOR has none of the usual regulatory limitations that hamper ordinary banks (e.g. publishing financial statements). It also owned a dozen of Panamanian-front companies, and on their behalf the IOR was issuing letters of patronage (support) to guarantee loans for Ambrosiano group companies.

In summer 1981, Calvi was convicted for currency irregularities related to share dealings in the Credito Varesino Bank and the Toro Insurance Company. Both companies were controlled by La Centrale, a financial company effectively owned by Ambrosiano. After this episode, the Euromarkets dried up as a source of funds for Ambrosiano subsidiaries. In June 1982, Calvi again had to turn to the IOR but it refused to renew the guarantees, and he unsuccessfully attempted to sell the block of Ambrosiano shares in order to meet financial obligations of the foreign subsidiaries. On June 18th 1982, Roberto Calvi committed suicide in London. The deposits dropped by 25 percent and the bank's business shrunk by 50 percent<sup>37</sup>, so the compulsory liquidation was ordered on August 6th 1982. A new bank, the Nuovo Banco Ambrosiano, was formed in just three days.

Although a final agreement with the bank creditors was reached in 1984, the investigation did not shed more light on the connections between the bank, on the one hand, and the Vatican, the Rizzoli publishing group (which owns "Corriere della Serra"), the Panamanian companies, the P-2 Freemasons lodge (of which Calvi was a member) and certain Swiss banks, on the other hand. However, it clearly highlighted communication "difficulties" in banking regulatory and supervisory structures - both in Italy and among supervisors from different countries.<sup>38</sup> This episode also led to the 1983 revision of the original Basle Concordat: it was realised that a divided supervisory responsibility should be extended to include the lender-of-last-resort functions. On these grounds, a consolidated supervision of risk-exposure and capital adequacy for a whole banking group was introduced. In spite of such regulatory improvements, there were still many loopholes that created conditions favourable for banking scandals, such as the BCCI affair, to erupt.<sup>39</sup>

BCCI was established in 1972 by a Pakistan entrepreneur, Agha Hassan Abedi, who wanted to create a bank that would help and assist Third World countries in their economic development. His efforts were backed by the biggest US

private bank, Bank of America (with a 30 percent stake in BCCI), and by Arab investors. Over almost two decades, BCCI grew rapidly: from being a 2.5 million dollars enterprise in 1972, BCCI developed to a 20 billion dollars bank in 1991.<sup>40</sup> It had over 400 branches in the network that spanned across 69 countries. Of a particular importance was its structure: it was registered in Luxembourg (for the lax regulatory environment therein), but it effectively ran international operations from London. Another vital element was BCCI Overseas, based in the Cayman Islands. More than two-thirds of the ownership was concentrated in the hands of Sheik Zaid bin Sultan al-Nahayan, Ruler of Abu Dhabi and President of the United Arab Emirates.

The bank's business evolved mainly in the field of international trade finance, where it effectively combined the principles of Islamic banking and international speculative opportunities. Islamic banking refers to a financial system used throughout the Muslim world that forbids interest charges. According to the Koran rules, surplus capital must not just earn bank interest, but it has to be invested in industry or trade. So, the banks are there to collect the accumulation and then to invest it in productive uses. Under Islamic banking, deposits do not bear a fixed interest and their nature is more similar to shares for they bring interest according to the profit of business in which they are invested.<sup>41</sup> In the case of BCCI, deposits were used to finance buying and selling commodities on spot and futures markets. Unlike other Islamic banks, BCCI was not "covering" itself for losses in those transactions by taking guarantees (e.g. a letter of credit) for the payment of commodities. In this way, the bank was exposing itself as a principal to serious risks on some of the most volatile financial markets.

The bank was particularly active in developing its retail business and at the time of the collapse, it had around 800000 depositors. It was not just individual depositors (mostly Asians) who trusted BCCI. Its creditors were, among others, charities (Oxfam, Save the Children), governments (Nigeria, Cameroon, Jamaica and Peru) and local authorities (councils in the UK), as well as some international organizations (e.g. African Development Bank).

In the late 1970s, BCCI started to tap the US market more aggressively. After the first unsuccessful attempt in 1978, Mr Abedi managed to buy a leading Washington bank, First General Bankshares, in 1981. It was said that the bank was independent of BCCI and C. Clifford, the former US Defence Secretary, became its chairman. From 1982 onwards, things were going worse and worse. In 1985, BCCI lost at least 150 million dollars in the Treasury-options market. In 1988, ten BCCI executives were charged in Florida with laundering 32 million dollars in drug money. In the following year, BCCI revealed the 498 million dollars loss and pleaded guilty to the charge of money laundering. Mr Abedi resigned as the president, the Abu Dhabi Ruler took control and injected 1 billion dollars into the bank. In 1991, BCCI was ordered by the Federal Reserve to sell First American

shares (previously, First General Bankshares), as it was found out that the acquisition had been improper. After certain unidentified BCCI officials had warned the Bank of England of illegal transactions, Price Waterhouse (BCCI auditor in the UK) was ordered to investigate. Upon the finding of a widespread fraud, simultaneous action was taken in Britain, the US and in some other countries to seize most of BCCI's assets and close its branches on July 5, 1991. This coordinated action resulted after several months of preparations, although it was said that the clear signs of troubles in BCCI had appeared a year and a half before. However, BCCI business came under the attention of regulators soon after its foundation.

In 1978, a US court affidavit showed that BCCI capital was insufficient for its operations and that its lending was crucially dependent on Bank of America's capital. This was one of the earliest documented signs about the problem of BCCI's creditworthiness. In 1980, the Bank of England turned down BCCI's request for a full UK banking licence. In 1983, when a new arrangement for sharing the supervisory responsibility had already been initiated, international banking supervisors became seriously concerned with BCCI. In 1985, the Bank of England approved BCCI's decision to transfer its treasury from London to Abu Dhabi. In 1986, the auditors Ernst & Young warned about excessive management power and weakness of the BCCI's system of internal control.

One of the most important steps in this direction was taken in 1987 when the "college of regulators" was formed in Basle, in order to organize an in-depth analysis of BCCI operations. The college consisted of regulators from Luxembourg, the UK, France, Spain, Switzerland and the Cayman Islands. Although BCCI was operating in 69 countries, no single country was ready to take full responsibility for it and "... BCCI became like a giant game of pass-the-parcel".<sup>42</sup> The college was thought to be an adequate "institution" for centralizing information and action regarding the supervision of such a large bank as BCCI. Regardless of the intentions, the college did not prove particularly effective, for it mainly concentrated on technical issues and never got the grasp of the whole entity of BCCI. Apart from the lack of power to enforce compliance with its conclusions, the college did not want to take direct responsibility for handling BCCI - the then-known irregularities were left to be settled by national regulators.

Two important but highly neglected signals of coming troubles were sent out by the banking community itself in 1988. When BCCI decided to expand its corresponding relationships, many large banks (e.g. Citibank, Bankers Trust) refused to have anything to do with it. They rejected the BCCI's proposals because of the dubious ownership structure of BCCI, suspicious financial transactions it carried out, and its relations to drug money. Then, in October 1988, 72 major banks suspended credit lines for BCCI, cutting it off from vital flows of cash.

In 1990, Price Waterhouse discovered false and deceitful practices by BCCI.

At the same time, a bail-out by Abu Dhabi was approved by the Bank of England. The Bank was later much criticized for its unwillingness to close BCCI and for the inability to react promptly. "The climate of opinion" in the Bank favoured BCCI's reconstruction for the uncovered irregularities were thought to be "isolated events" and not of a systematic nature. Later in 1990, the Bank of England was told that BCCI held accounts for Abu Nidal, the Palestinian terrorist organization. In November 1990, auditors discovered private files of top BCCI's executives containing many details of fraud. The Price Waterhouse report was commissioned by the Bank in March 1991 and it led to the BCCI closure in July 1991.

So, it took the regulators 13 years to reach the conclusion at last that BCCI grew to "an elaborate corporate spider-web", which facilitated fraudulent operations to be carried out on the world scale. Two independent inquiries were initiated, in the US, under Senator John Kerry, and in the UK, under the Lord Justice Bingham. The findings were astonishing and the presented list of irregularities in relation to BCCI operations is huge.

"You name it, and the Bank of Credit and Commerce International probably has been accused of doing it. Yet for almost 20 years, BCCI nearly always managed to stay ahead of the law."<sup>43</sup>

Although it is not certain if the list is complete, it can be summarized as follows.<sup>44</sup> BCCI was keeping relations with Colombian drug cartels and was laundering drug money. It was producing falsified accounting records. It used external vehicles to channel transfers of funds and created a network of 70 companies to facilitate and disguise its lending operations. BCCI illegally acquired the bank in the US, hiding behind "independent" investors. It handled flight-capital from throughout South America: it was transferring deposits among branches so as to hide cash from the IMF in these countries. BCCI was charged with tax conspiracy and fraud in the sale of securities. It was discovered that it extended "bad" loans of about 2 billion dollars to rich Gulf families. These loans were granted without adequate collateral, and sometimes without any legal documents or agreements. It was found out that some of these payments were made to fictitious accounts and were actually "covering" business losses. Even in the cases when "real" credits were granted, interest payments were late or non-existent.

It was unveiled that BCCI kept close relations with high politicians in many countries. BCCI used "influence-peddling" as a powerful means to achieve concessions and a better position in the country concerned. It was found out that BCCI made payments to Zimbabwean politicians in London during the 1979 Lancaster House negotiations on Zimbabwe's independence. Soon after independence, BCCI became the first foreign bank to obtain a licence in Zimbabwe. It is assumed that BCCI acted similarly in a number of Third World countries, including payments and favours to the Gandhi family in India and to General Zia of Pakistan. The bank maintained "special" relations with influential politicians in the

US and UK, among others with Jimmy Carter and James Callaghan, as well as with some other influential figures like Panama's dictator, General Noriega. BCCI had also special "agreements" with leading Washington law firms which acted as lobbyists. Its relations within the US were further strengthened when C. Clifford was appointed the chairman of First American, having in mind his connections dating from times when he was the Defence Secretary. BCCI's public relations departments were very active in creating the bank's image as an institution deeply concerned with problems of developing countries in Latin America, Far East and Africa. Its Charity Third World Foundation was registered in the UK, and it had been presenting the Third World annual prize in the period from 1980 to 1988. The prize was being awarded for remarkable achievements in economics and politics concerning developing countries' problems.<sup>45</sup>

In short, BCCI was conducting a vast range of criminal activities and this scale of "business diversification" was made possible by two basic causes. One of them is undoubtedly the speculative and fraud skills of BCCI's head. Nevertheless, this global network of manipulation could not have become so efficient if there had not been the other cause - the lack of any comprehensive and consistent supervision of its activities. Whether this lack can be attributed to negligence or to lack of authority and resources, it stands clear that regulators failed to react adequately.

One of the most extensive critiques of the role of the Bank of England in the BCCI affair came from the Treasury and Civil Service Select Committee.<sup>46</sup> The opposition MPs on the Committee used stronger language than in the official 1992 Report, implying that the Bank was well aware of the difficulties in relation to BCCI even before March 1990.

"We believe the Bank was not anxious to expose corruption in Abu Dhabi or the part that Saudi Arabia's biggest bank, the National Commercial Bank,...played in hiding huge frauds in BCCI. If this did happen, then it constitutes a clear fraud on the depositors by the Bank of England."<sup>47</sup>

Such a strong criticism was accompanied by several proposals from the Committee about the system for regulating international banks. The Bank of England should lobby for an amendment of the 1983 Basle Concordat. It should be agreed among the regulators that every single international bank must come under proper supervision of a single regulator, so that the whole bank's entity can be supervised. More details about the efforts to coordinate international supervision through the Bank for International Settlements will be presented in the sixth chapter.

The Committee suggested that an independent international body should be established to monitor the imposed supervisory standards, i.e. to supervise the supervisors. Through sharing the supervisory responsibility for international banks, the Bank should receive reports on branches of foreign banks operating in the UK. A bank's accountants should be "obliged to ignore" their duty of client confidentiality and report to the Bank any discovered irregularity. Furthermore, the

Bank should expand its "on site" inspection of banks, in a way similar to investigations carried out in the US.

In addition, the Bingham report suggests that the Bank of England's internal communications should be improved and additional powers should be conferred upon it. The latter primarily concerns the explicit power of the Bank to refuse or revoke banking authorization, if a bank cannot be properly supervised. In the case of BCCI, it was the complex structure of the banking group that inhibited a clear supervisory view over the whole organisation. The report also calls for more uniformity and harmonization of supervisory standards within the EC in order to eliminate opportunities for "supervisory arbitrage". In the case of BCCI, the "arbitrage" pointed out Luxembourg as the most favourite (most lax) environment for the BCCI's registration. In the field of international supervision, the Basle Committee<sup>1</sup> should continue to perform the leading role. As to the geographical distribution of a bank's operations, it was suggested that certain financial centres offer "impenetrable secrecy" as a competition weapon. Therefore, the involvement of such a centre should sometimes be the sufficient ground for refusing or revoking authorization.

The Bingham Report has had a profound impact on debates about the role, capabilities and powers of the Bank of England, as well as about the financial regulation in general. On the day when the Bingham report was published (October 22, 1992), the Chancellor of the Exchequer announced that the Government and the Bank of England had accepted all of the recommendations from the Report. The Bank of England undertook specific steps in order to improve its supervisory and regulatory functions. It was announced that a Special Investigation Unit would be established and that the Banking Supervision Division's Legal Unit would be strengthened.<sup>48</sup> However, the Governor of the Bank of England, Mr. R. Leigh-Pemberton, rejected the "accusations" that the Bank was reluctant to use its powers.

"The Bank had to consider very carefully whether its powers were exercisable and whether if they were it was in the interests of the depositors that they should be exercised."<sup>49</sup>

In the beginning of 1993, a conclusion was still not reached what were the interests of the BCCI depositors: closing of the bank when the first signals of fraud appeared, or insisting on its restructuring and on the maintenance of business. Moreover, it was not apparent what were the interests of BCCI regulators, nor those of the home country and host countries. If one excludes the case of an intentional "negligence" of the regulators, the problem may originate from the intersection of different values and stakes pursued. For example, there was a value of freedom to operate (i.e. freedom to deposit money with a particular bank), on the one hand, and a value of security (economic security of the depositors), on the other hand. The values of

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<sup>1</sup> The Basle Committee on Banking Supervision is analyzed in the Chapter 6, section 2.4.

order and honesty were also cut across, particularly in respect of a delicate question on who should "police" that order.

The BCCI affair presents not only the biggest banking failure but also the "incident" that launched some of the most comprehensive and substantial analysis of modern banking. Almost every aspect of international banking has come under scrutiny: banking structures and financial techniques, accounting practice, auditing and supervision, legal aspects, and, most notably, international regulation.

"The focus of attention in the aftermath of this debacle should not simply be to prevent a second BCCI (although the aim must of course be to achieve that at least). But the aim must also and more importantly be to ensure that supervisory law, principles and practice generally create conditions hostile to the growth of fraud and friendly towards its early detection and eradication."<sup>50</sup>

For that purpose, it is essential to overcome the inter-national approach to modern banking. That approach was probably adequate and useful in times when banking across borders included controllable transactions between well defined regulatory areas. Today, international banking accounts for a smaller part of the overall financial flows. Instead of the international approach, a global strategy should be developed, to encompass not only a great number of financial regulators, but also to include cooperation with global banking community. It should also provide links with the regulators dealing with other issues such as terrorism and drugs.

So, all three mentioned large "financial threats" - the Third World debt crisis, the 1987 stock market crash and the BCCI affair - add another component to the on-going evolution of perceptions concerning modern financial markets. It has been realized that financial markets are by no means separated from the "real" economy. Furthermore, every country's "real" economy is an integrative element of the world economy. It has become obvious that protectionism and regulative barriers are no longer obstacles which cannot be surmounted. The so-called over-development of financial markets during the 1980s produced financial excesses of the scale never seen before. However, the 1987 crash underscored that such sophisticated financial markets do require new attitudes towards them. The BCCI affair illustrates what can happen in the absence of a comprehensive system of international regulation. Having in mind the scope, size and reach of these markets, many of their classical (theoretical) functions need a critical re-examination.

The three "incidents" described above were chosen on the grounds that all three were actually "allowed" to happen by the system itself.

Particular financial scandals erupted during the late 1980s and in the beginning of the 1990s. The Drexel Burnham Lambert case in 1990 revealed losses of about 8 billion dollars, with tens of thousands of investors ruined.<sup>51</sup> There was a series of stock-for-favours scandals in Tokyo between 1988 and 1991, involving the top securities firms, large industrial corporations and high politicians.<sup>52</sup> In



April 1991, Salomon Brothers, one of the leading US securities firms, "cornered" the Treasury securities market by acquiring, in an illegal manner, more than 35 percent of the outstanding bonds. The Maxwell affair in the UK broke out in November 1991, followed by discoveries of massive fraud, transfer of funds between public and private interests and various financial irregularities.<sup>53</sup> Without any intention to underestimate the reach and consequences of these scandals, they could not be perceived as global financial threats.

Specific regulatory ruptures persist in the world financial system and the climate created therein has always been more than favourable for various speculative, fraudulent and, in general, uncontrollable activities to be undertaken. The task conferred upon the world community is to create a regulatory framework, within which the global financial system would operate. One purpose of such a framework would be to provide the most efficient allocation of world capital. Another, complementary purpose would be the exercise of regulation and supervision on a truly global basis. It is the field of international relations theory that could probably offer some of the explanations how such frameworks are built.

## CHAPTER FIVE: INTERNATIONAL RELATIONS AND FINANCE - THE GLOBALIST APPROACH

The analysis presented in the previous chapters was basically done within the framework of economic theory. That was necessary in order to understand the very essence of the subject itself - the global securities market. For that purpose, the global market has been defined and explained from various aspects and upon different criteria, as much as it was possible within the current state of economic theory. The length and extent of the economic analysis in this work can be justified on the grounds that the critical approach was taken, in contrast to the problem-solving approach.

"Critical theory, unlike problem-solving theory, does not take institutions and social and power relations for granted but calls them into question by concerning itself with their origins and how and whether they might be in the process of changing. Critical theory is directed to the social and political complex as a whole rather than to the separate parts."<sup>54</sup>

However, certain developments in the sphere of global banking seem not to have been properly examined. This has always been the case for economic developments that are difficult, or impossible, to quantify or determine by "classical" tools of economic theory.

All of the previous chapters have clearly underscored that the global securities market has outgrown the state and its national economic policy domain. It has happened so not just according to the "technical" side (e.g. by using financial techniques that allow the world-wide allocation of funds), but also in respect to the issue position on the international relations agenda. A market of such reach and complexity could not be either supervised or "managed" by any single state actor. Moreover, as the following example will illustrate, it has reached a stage in its development where it could not be separated or isolated from developments in other fields of relations in the world community. Furthermore, as the previous chapter on the latest financial threats has emphasized, cross-border capital flows can exercise significant influence in many other spheres of global politics. This is a new distinctive characteristic of modern finance: it has become so interwind with the whole of international relations that the theoretical framework for its analysis must be widened, to become a multidisciplinary one. In this particular analysis, the analytical framework is going to be enlarged by adding the International Relations perspectives on today's world. Then one of the four paradigms, the globalist

approach, including regime theories, is going to be presented in more detail. It will be useful to illustrate with a short case study the development of the relationship between high politics and high finance, before displaying a brief comparative survey of the four main approaches to international relations

### 5.1. Petrodollars and hostages

Two historical examples of the early stage in the evolution of the relationship between politics and finance were presented in the first chapter. One of the best recent examples of this kind relates to the inflow of OPEC surplus funds to international capital markets in the 1970s, most notably to the US market. The concerns that were raised, in relation to "Arab money" in the US, have marked the beginning of a new stage in the interplay between high politics and high finance.

Following the first oil-shock in 1973, OPEC countries such as Saudi Arabia, Kuwait and the United Arab Emirates increasingly turned to the US capital market. The quantitative side of that development is summarized in Table 3.

Table 3: ARAB MONEY IN THE US, 1974-1983 (billions of dollars)

	1974	1981	stock end 1983	market share
US gov. securities	3.2	14,0	39.9	17%*
-T bills	2.1	1.1	6.3	na
-T bonds	0.2	11.2	27.9	na
Corporate securities	0.2	2.8	13.7	1%*
Bank deposits	2.0	-2.5	6.8	2%*
Direct investment	0.07	2.7	4.0	...
Total funds	6.0	16.3	72.9	-
Funds in US banks' foreign branches	na	na	13.5	-

\* percent of all foreign holdings of securities or deposits

(Source: COHEN B. [1986] "In Whose Interest" [New Haven and London: Yale Univ. Press])

When the money started to flow into the US market, the Government appeared to be pleased with the amount of extra-accumulation provided from abroad. At the end of 1983, the stock of inflowing capital amounted to nearly 100 billion dollars. It was said that an inflow of that amount would definitely be beneficial for the US

economy. The supply of funds for US enterprises would be improved and this would eventually invoke further investment, create new jobs and positively effect domestic growth. The improved supply of funds would prevent any serious increase in interest rates. Furthermore, it was said (whatever was really thought by the Government) that this extra-accumulation would be beneficial for the budget deficit, the balance of payments the and exchange rate of the dollar. Nevertheless, as the funds were flowing in and the stock of OPEC holdings was piling up, critics were becoming more and more concerned with the significance of this development.

Suddenly, there appeared to exist a wide-spread fear about the leverage OPEC countries had gained by "buying-out" America. Warnings came that a sudden run on these holdings could severely damage the US financial institutions involved in taking petrodollar deposits. It was said that certain acquisitions made by the OPEC countries in the US, in the so-called hi-tech sector, could uncover precious technological achievements. In this way, the OPEC countries could obtained an easy access to hi-tech laboratories, patents, know-how or even classified information. Even worse, there was consternation that the withdrawal of funds and their "switch" into other currencies could seriously effect the exchange rate of the dollar. Both aspects, the positive and the negative, of the OPEC financial inflows were greatly exaggerated, as Table 1 shows. The funds just could not be of the importance publicly attached to them, whether by those praising or by those criticizing the situation.

What has to be mentioned here is that, for the first time, the US government publicly admitted the existence of possible linkage strategies that could be employed by the net-creditors of the US, such as OPEC countries. An equally important point is that the Government had set certain standards in dealing with Arab money (e.g. a high level of confidentiality and secrecy concerning petrodollars) that came to please both the investors and the recipient US banks. By deliberately reducing market transparency for these particular assets, the Government improved the competitive position of the market, relative to markets abroad. At the same time, it was a direct manifestation of politicizing high finance.

"In the middle 1970s, the maintenance of amicable relations with Arab governments, and in particular with Saudi Arabia, was deemed an overriding foreign policy objective for a variety of reasons, political as well as economic."<sup>55</sup>

Apart from the economic benefits mentioned above, it was thought that "amicable" relations would enable the US government to influence OPEC countries in relation to several matters. A moderation of oil prices was hoped for, as well as the retention of market share already achieved there by US corporations. A continuous and substantial inflow of OPEC funds would prevent serious disruption of government-business relations at home, which would certainly occur if monetary policy had to be tightened due to inadequate supply of capital. Away from these

national economic goals, friendly relations were sought to support certain foreign-policy goals in the Middle East. A rising anti-Israeli tone that was spreading through the Arab world could adversely affect the US position in the region. Friendly relations with such influential countries as Saudi Arabia would eventually strengthen US initiatives in peace negotiations.

However, the concerns that arose with regard to the OPEC funds drew attention to a number of other matters. The OPEC requirement for privacy and secrecy highlighted a very sensitive and somewhat contradictory relationship that existed in the triangle of the Senate, the FED and money centre banks. Actually, the Senate could not fully exercise powers conferred upon it: its Foreign Relations Committee could not get adequate data from commercial banks on the real significance of the Arab money in the US. On the other hand, the Federal Reserve was in fact acting as a foreign-policy maker: it would itself collect the "sensitive" data from banks, aggregate it and convey it to the Senate. All this would have to be done in accordance with the foreign-policy goals "of the day", as determined by the FED. Most importantly, the banks established themselves as active participants in the political process: they were vigorously lobbying for their Arab clients' requirements, fully aware of the potential foreign policy effects of their activities. Under these circumstances, the government had to resume a difficult role of balancing private interests of the banks and public interests - "national" goals of the country as a whole. Nevertheless, the OPEC funds in the US did not prove to be of any profound political value for the investors at the time. It was in 1979, when the role of petrodollars in the US was dramatically changed. From being a potential threat to US national goals, petrodollars became the most practicable weapon to achieve the goals.

The American embassy in Teheran was seized on 4 November 1979, together with sixty-six hostages. Ten days later, all Iranian assets, totalling about 11 billion dollars, were frozen. This concerned not just the assets held in American banks in the US, but also Iranian funds in the foreign branches of US banks. The action was initiated and completed within 15 hours from the time the explicit warning came from Iran. On 13 November, the then acting foreign and finance <sup>minister</sup> of Iran, Abolhassan Bani-Sadr, warned that Iran was going to withdraw all his funds from the States, because the US were carrying on economic war against his country. Although certain preparatory measures in this course had been carried out since February 1979, legal grounds for this action had actually been set sixty years before.

In 1917, the Trading With the Enemy Act was passed, in order to confer extra powers upon the president. He was empowered to regulate various domestic *and* international transactions for an *indefinite* period, in cases of war *and* peacetime national emergencies. This act had been the basis for freezing other countries' assets in the US on several occasions, as with China, Cuba, North Korea, Vietnam and

Cambodia. In 1977, the president's power to regulate transactions were broadened and specified with the passage of the International Emergency Economic Powers Act (IEEPA). Thereafter, the president would be able to undertake 'special' actions, if the national security, foreign policy or *economy* of the US were to come under threat from any external event.

After the embassy seizure in November 1979, Iranian assets were frozen under the terms of the IEEPA and this was seen basically as a defensive strategy. The stability of the US financial system, as well as the dollar exchange rate, were perceived as being in jeopardy. Shortly after the freezing, it was the Iranians who actually built up the linkage between the frozen assets and the release of the hostages: they would not be freed before assets were returned to Iran. This gave the US additional bargaining strength: what was thought to be a potential weapon to be used against them (the Arab money weapon), turned out to be an effective instrument to be used against others. The need to act for a 'pure' economic emergency (the stability of the system and the dollar) was successfully used as a link to foreign policy goals.

Another important aspect of this linkage has to be pointed out. In spite of the linkage effectiveness, in the eyes of the public (especially foreign public) the economic danger had to be kept clearly apart from the foreign policy disturbance in relation to Iran.

"All that talk about the dollar and US financial institutions was really just a smokescreen - propaganda designed for the consumption of other governments, particularly the oil-rich Arab states, who might worry that if the money weapon could be turned on the Iranians it could be turned on them too."<sup>56</sup>

There was no desire to endanger amicable relations with the Gulf countries, partly because of a highly beneficial inflow of their funds at a time when the dollar was still weak, and because of a continuous US interest in the Middle East. The government realized that a political explanation for the asset freeze could provoke chain reactions on the part of other countries depositing with US banks. That could really have threatened the system and the exchange rate.

At home, there were additional problems in relation to the freeze. Banks that had extended credits to Iran wanted to have their claims offset against Iranian deposits. There were also a number of non-bank claimants, who could not compensate themselves for eventual Iranian defaults with the deposits. Concerning the relation between the banks at home and their foreign branches, the situation was even more delicate. What actually happened was that only bank branches operating abroad obtained Treasury authorization to use Iranian deposits to off set outstanding Iranian loans. Apart from the problems that arose due to different treatment of US banks at home and abroad, there was the major problem of the extraterritorial reach of the freeze order. Years after the affair, it was still difficult to explain upon what

grounds tacit approval of other countries (that hosted branches of US banks) was granted for this unprecedented action.

Another sensitive matter that had to be resolved concerned non-performing Iranian loans and a possible use of a cross-default clause on part of the banks. Application of this clause would enable other banks to require immediate repayment of the loans they had extended, if any one loan (granted by another bank) would be declared in default. If, for example, Iran would declare his loan granted by Citibank in default, other Iranian creditors could call on their loans as well. Eventually, this did not happen, as a number of banks perceived some investment opportunities still to be open in Iran. In relation to this, there was the problem for the FED concerning adequate information about Iranian assets held in US banks. On the grounds of maintaining the principle of secrecy and confidentiality for Arab clients, banks were not willing to disclose data on their holdings. What was originally introduced in order to "safeguard" inflow of funds from the Gulf, became a serious obstacle for the government in developing its strategy towards Iran.

Regardless of the various problems, a negotiation process started after some time. What is of a great interest for the purpose of this discussion is the structure of the negotiations. There were actually two parallel tracks: one between Iran and the banks, and the other between the two governments. The banks were approached first by the Iranians, but they could enter negotiations only after they had obtained the government permission. Intermediated by the government of Algeria, there were parallel inter-governmental talks that took place in highest secrecy.

"The strategic interaction between the US government and Iran was considerably complicated by the actions and influences of private financial institutions, whose interpretations of their commercial interests in this affair did not always coincide with the public interest... As the two tracks [of negotiations] gradually merged, administration officials spent as much time bargaining with the banks as they did with the Iranians."<sup>57</sup>

Additional problems arose in relation to the interest to be paid on the Iranian assets held "on freeze". The banks that were actually using those funds for free were not willing to accrue interest. On the other side, a sort of a "coalition" was building up between the Iranians, the US banks that did not have Iran's deposits, non-bank claimants in the US, and a number of foreign banks that criticized this highly advantageous position of the US banks. Each of the coalition members had its own genuine perspectives and motives, but they all shared the same goal.

At the end, unfrozen assets were returned to Iran but only partially - almost 50% was used to offset Iran's non-performing loans and to meet obligations to non-bank institutions in the US. The hostages were released and the sanctions lifted.

This whole episode was much more complex, but for the purpose of this study even a brief presentation clearly underscores several important points. The affair was among the most obvious examples of complex interdependence that exists

in the contemporary world. Very sensitive and mutually limiting relations between high politics and high finance were explicitly highlighted. Secondly, all actors seemed to become aware of the dialectic between their mutual interests and mutual aversions. They realized that their goals and interests may vary across time and space, but they are inseparably linked and mutually influencing in that process of changing. It was perceived that the same dialectic characterizes the complexity of actors' goals and motives within one state. Certain parallelism (certain broad similarities) do exist in their strategy, but there is also a significant degree of collision in relation to the pursuit of their interests. What is even more interesting, certain goals were widely shared among different types of actors (e.g. the matter of interest to be paid), regardless of their basic motives.

Thirdly, it became apparent that such an affair necessarily involves all sorts of actors in international relations. Apart from the conventional governmental actors directly concerned, such as the US State Department, it developed to include a number of other governmental, such as the US Federal Reserve, and non-governmental actors.

Fourthly, different sectors of the US government in this case had to resume a role of balancing "national" goals between themselves (e.g. the foreign policy threat v. the economic need for foreign accumulation). They also had to act in a way to achieve a "compromise" between national, public goals (as interpreted by themselves) and private goals expressed on part of the banks. In this particular case, the "list" of national priorities seemed to have been turned upside down: it was the economic emergency that became the top priority. A dialectical nature of public interests in different fields was openly accepted and that made the linkage even more effective.

As the fifth point, it has to be mentioned that the hostage affair brought to the forefront the importance of intra-governmental structures and relations. It was the unity of the governmental "voice" on part of the US that certainly improved its position in negotiations with both the banks and Iran. On the Iranian side it was not the case, for rival political factions in Teheran used the affair for their own immediate goals. Although the FED acted as a foreign-policy maker, no mixed or confusing signals were sent out from the government. This was a clear illustration of the Globalist assumption that a government is not a single body: it consists of various segments, levels and departments which can separately pursue their own strategies and interests.

The purpose of this example was to illustrate the choice of theoretical framework among the four main paradigms of international relations. Albeit this was not an example directly related to the global securities market, it can enrich the comprehension of the global environment wherein this market has been developed.



## 5.2. International relations - main perspectives

The first question regarding the extension of this analysis is why should one study basically an economic phenomenon from the aspect of another discipline, namely that of international relations. As has been noted, the underlying aim is to offer new, critical insights for understanding the rise, the structure and the processes of the global securities market. This can be done only if the particular phenomenon is located within a broader social and political context, so that the complexity of the whole and of its parts can be comprehended. The scientific field of International Relations provides one dimension for the extension of this analysis because it is concerned with

"... relationships between individuals or groups, who are members of different states, or between the states themselves."<sup>58</sup>

Moreover, as the kind of relationship concerning capital flows has developed to the extent outlined in the third chapter, the International Relations' approach to the global environment seems particularly useful. J. Rosenau identifies the main scope of International Relations as

"... encompassing all general and specific analyses of the international social system and its various subsystems. The international social system may be thought of as a series of interdependent, functional subsystems; the international political system is the most important of these subsystems... Among the other constituent functional subsystems are an economic system, a legal system, an ethnic system, and a scientific system..."<sup>59</sup>

From this point of view, it is clear that contemporary phenomena emerging on the world scale are functionally interrelated and "just" parts of the complex whole. Rosenau goes on and underscores a multidisciplinary approach that has to be taken, including political but also military, economic and technological studies. Although his views later underwent certain changes (more attention to his work will be paid later in this chapter), Rosenau's early conclusions about different and definable sectors - areas - within the global system have had a profound impact upon theoretical progress. According to this perspective, International Relations should cover all "instrumentalities and forms" (Rosenau, 1976) of interactions between political actors that transcend state borders, covering diplomatic, military, economic, psychological, legal, ethical, technical, scientific and/or cultural interactions. These interactions may occur within or between different sectors, and may involve different types of actors, each of them pursuing their own values, interests and strategies. Multiplicity and a high interrelatedness of these political relations and links (within and across sectors) actually determine effects and outcomes at all

levels: at the general (systemic) level, at different subsystemic levels, and at the micro-level of each single actor. Apart from states, as the most obvious actors in international relations, all sorts of different actors have also to be taken into consideration. For the course of this analysis, Rosenau's conclusions about other-than-governmental actors are specially instructive.

"The importance of non-governmental actors is a function of their power base, their independence from governmental power, and the ways in which their acts and goals are related to those of governments."<sup>60</sup>

In short, International Relations should study political actors, structures and processes being developed within and between different sectors of the world polity, i.e. of the global environment. This resembles the wider concept of international organization, used by P. Willetts, to describe

"... regular patterns of interactions between interdependent sets of government bureaucracies, transnational corporations, non-governmental organizations, international non-governmental organizations, iquangos and international governmental organizations, utilizing differential abilities to gain access to communications structures, in order to pursue contention over an issue."<sup>61</sup>

In respect of both basic assumptions and theoretical findings, four main approaches to the study of international relations can be identified. They are conventionally labelled as Realism, Structuralism, Functionalism and Globalism, but they can be also discovered under other names, for example Power politics, Dominance and Dependence, World Society and the Issue-paradigm, respectively.<sup>62</sup> The first three of them will be presented only briefly, except for some parts of the Realist approach. The Global Politics approach will be introduced in more detail, as it will serve as the theoretical framework for analyzing the politics of the global securities market.

### **5.2.1. The Realist perspective**

One of the most widely held perspectives on international relations is certainly the Realist approach, alternatively labelled as the state-centric or power-and-security approach. The literature on this approach is vast and diversified<sup>63</sup>, but some common, basic assumptions and findings can be identified. The key words (concepts) in this paradigm are: the state, power, the national interest, conflict and struggle, international anarchy.

Sometimes described as the most "elegant" approach, it is also portrayed as simply consisting of beliefs in the wisdom of certain "eternal verities" about politics.<sup>64</sup> These verities concern the dominance of the state in the global

environment. They also point to the state's constant pursuit of the national interest by rational decision-making, in a continuing struggle and conflict with other states. Realism takes the systemic level of analysis, and is basically conservative and dogmatic in nature.

The state is in focus, for it is the only actor that features legitimate use of force, within and beyond its jurisdictional boundaries. The state is a unified political actor due to a high level of cohesion in its structure. Cohesive components are assumed to include the attribute of sovereignty, nationalism, a geographical base, economic resources and links, a common language, and social and cultural patterns. Its highest objective is to define and pursue various national goals and the overreaching national interest of security. The pursuit of unified objectives is carried out through domestic and foreign policy, with the ultimate task of displaying a high level of military strength and economic capacity to other states. In doing so, the state enjoys full autonomy, as the consensus over national priorities legitimates its actions.

The most important characteristic of the state, but also the most important weapon in international relations, is a real and perceived power.

"Power in international relations is the capacity of a nation to use its tangible and intangible resources in such a way as to affect the behaviour of other nations."<sup>65</sup>

These sources of power include geography, natural resources, population and the nature of a country's government (tangible resources), as well as national character, morale, ideology and the quality of a country's leadership (intangible resources). Of all the "powers", military power is the indispensable instrument of national survival, in times of both internal and external jeopardies and threats. K. Knorr distinguishes power as a means that could be accumulated (primarily on a basis of a country's economic strength) and eventually used, from power as an effect and influence that is actually produced and enjoyed.<sup>66</sup>

The pursuit, preservation and improvement of the national interest is the state's most significant task. There is no common explanation of the notion "the national interest". Sometimes it is referred to as the overall common good of the entire society (nation), and yet sometimes it covers concrete stakes (objects) which the state bargains over in international relations. However, "the national interest" is frequently mixed up with "the state interest" for the separation of the nation (the society) from the state does not exist within the Realist framework.

"The national interest is itself an objective reality that does not depend on the aims selected by policymakers. It is the end of maintaining the capacity of the state... to protect the society while it continues its search for its shared good."<sup>67</sup>

The environment which this state system operates within is a dangerous anarchy, created by the actors' pursuit of their own, particular interests. Each actor

faces a constant security dilemma from its own perspective, and actions resulting therefrom (e.g. arms race) cause further deterioration in the actor's environment. As a country's position within the hierarchical world structure can only be improved with the relative decline of other states, struggles and conflicts are inevitable. Although a country's status can be improved or worsen, there is very little possibility of a radical change of the order itself.

Neorealism accepts basic assumptions but adds much more of a "realistic dimension of realism". Namely, dissatisfied with both descriptive and explanatory capabilities of classical Realism, writers have increasingly turned their analysis to the existing world. The power-and-security tradition seems to have been losing its strength.<sup>68</sup> Neorealists accept the basic structure of the state system, but allow the appearance (though less significant) of relations other than that of states, and admit the rise of different types of actors in the world of politics. The umbilical cord with the core of Realism is the assertion that other-than-state relations are possible only if the state actors allow them to develop. Transnational processes may become parallel or contradictory to inter-state relations, but they can by no means surpass or rival them.

An important additional assumption, brought forward by R. Keohane, concerns the possibility of cooperation in international relations. Interests are still conflicting, but even so, direct confrontation can be avoided if cooperative management, negotiations and policy coordination are introduced.

"Intergovernmental cooperation takes place when the policies actually followed by one government are regarded by its partners as facilitating realization of their own objectives, as the result of a process of policy coordination."<sup>69</sup>

Different issues that arise on the world scale are seen as being interrelated (H. Bull<sup>70</sup>), and a concept of relative power is developed. This concerns a state's power available and exercisable in a given sector, or power in relation to a particular salient issue. The power of Switzerland, or more precisely of its banks, to attract and manipulate foreign capital is a classical example of issue-specific power, as being very distant from the Realist understanding of power. However, the state is still the condition sine qua non for the preservation of the system as a whole and of its parts.

"The structure of international trade changes in fits and starts... Nevertheless, it is the power and policies of states that create order where there would otherwise be chaos or at best a Lockian state of nature. The existence of various transnational, multinational, transgovernmental, and other nonstate actors... can only be understood within the context of a broader structure that ultimately rests upon the power and interests of states..."<sup>71</sup>

Another distinguishing feature of Neorealism is a significant attention they pay to

economic issues.<sup>72</sup>It was exactly within Neorealism that an attempt was made to introduce a new theory, International Regimes, into the main paradigm. Theoretical approaches to international regimes will be presented in depth in the concluding section of this chapter.

### 5.2.2. The Structuralist perspective

This paradigm presents a "left-oriented" theoretical response and although it seems, at first, to contradict the Realist approach, it actually upholds basically similar assumptions. Writings on this perspective can be found as categorized under the labels such as Dominance and Dependence, Marxism, Global social class, the Global centric approach, and the World System perspective. This literature is even more diversified than the Realist one, with respect to the level of analysis as well as the subjects and relations under examination.<sup>73</sup> The key words are: the class structure, the state, economic determinism, uneven development and exploitation. Its theoretical root is undoubtedly Marxism, even though this has not been recognized (accepted) by some of the writers. The main heritage therefrom covers the systemic approach to analysis, without disaggregation from the top down, and a rigid form of determinism on economic (class) grounds.

There are two main types of actors in international relations: classes and governments (state apparatus). The latter type essentially provides "building blocks" for the global system, which is held to be very state-centric. Classes enter international relations either through actions of their governments, or directly through linking with corresponding social strata abroad. This disaggregation of the "state-as-country" (Willetts) on the government and the society is certainly among the most significant achievements of the paradigm. Resulting from the separation, there is a constant, inherent conflict of interest among and between these two components of the state. At the system level, it is supposed that there is a unity of interests among classes that are in the same position in the economy, regardless of their national location. Recent writings on the expansion of multinational corporations and in the Dependencia school have somewhat modified these oversimplified assumptions.

O. Sunkel and E. Fuenzalida pointed to the emergence of a new type of actors - transnational communities. These transnational communities are formed on the basis of the same characteristics shared by groups of professionals.

"The stratum of society that we have called the transnational community is made up of people that belong to different nations, but have similar values, beliefs, ideas (and a lingua franca - English), as well as remarkably similar patterns of behaviour as regards career, family structures, ..."74

The focus of interaction in international relations is on contradictory but interdependent economic interests of different classes, with the interests of the

dominant capitalist class being protected and pursued by actions of their governments. Effectiveness of that pursuit relies on the position of the country within the hierarchical world structure.

"The functioning of a capitalist world-economy requires that groups pursue their economic interests within a single world-market, while seeking to distort this market for their benefit by organizing to exert influence on states, some of which are far more powerful than others but none of which controls the world-market in its entirety."<sup>75</sup>

The global environment for international relations is marked by inequality among states, uneven and centralized development, and by exploitation and dependency as main processes. There is only one global, world system, made up of states. Accordingly, there is a single, global capitalist economy (market), through which the separation between the centre (developed states) and the periphery (underdeveloped, dependent, backward states) is fortified. Power in international relations is perceived to be primarily economic in nature, but it can be "supported" or enhanced by military force or threats if necessary. From this perspective, conflict is by far the most dominant form of international relations, where bargaining and compromising that significantly alters outcomes rarely occurs. So, there is a very narrow possibility of change, if the extremely revolutionary pace (destruction of the system) is excluded.

Apart from the already mentioned disaggregation of the state, this perspective accurately points to the fact that the government is not an independent body which organizes and exercises its functions autonomously. Moreover, various questions that arise in international relations are increasingly treated as being interrelated. However, as the theoretical foundation (Marxism) of this perspective does not offer a coherent set of ideas concerning international relations, contemporary writings in this tradition appear to have been declining in significance.

### **5.2.3. The Functionalist perspective**

The Functionalist paradigm has evolved as an expression of dissatisfaction with growing nationalism and totalitarian ideologies most obvious in the 1930s and 1940s. On those grounds, the functionalist paradigm was being developed as predominantly a normative (idealistic) approach that outlines what the base and forms of international relations should be. Contemporary writings in this approach originate from David Mitrany's work in the beginning of 1940s, and from the work of K. Deutsch on international integration.<sup>76</sup> The key concepts are economic and social groups, task-oriented organization, common welfare, interdependence, cooperation, knowledge and skills.

In its early stage, the Functionalist paradigm rejected the state as the main and legitimate actor in international relations. It was the use of force and the abuse of ideologies that had delegitimized the state as the representative of the national interest. Moreover, the state was not even in the condition to pursue national goals effectively, as economic integration and interdependence had made state borders futile. An ideal world would be structured according to functions that have to be performed in order to achieve common welfare. This structure would be organized with respect to functional efficiency but regardless of geographical (state) borders. Main actors would, hence, be certain socio-economic groups that would cooperate for common benefit.

The idea of over-reaching cooperation, on a voluntary basis, was further developed in the concept of "World Society" (J. Burton). The global system presents a complex of networks, interactions, built through various contacts and communications in the field of economic, cultural and social exchanges. This is exactly the most important finding in the realm of the Functionalist perspective: the origins of cross-border cooperation were accurately located in functional interdependence developed between modern societies. In addition, by highlighting the significance of "separate" functions, this perspective has paved the way for developing a sectoral approach to international relations. By the same token, the importance of non-governmental actors was accurately valued, as well as other-than-military national priorities.

Neo-Functionalism accepts the basic assumptions of the Functionalist perspective, but also adds some new elements to the paradigm. Most importantly, it adds the possibility of conflicts that may arise on the international scene, and accepts the existence of states as actors in international relations. The state behaviour, however, is not autonomous but under a significant influence of socio-economic groups that possess highly specialized knowledge. E. Haas is among the most prominent authors that has been developing this idea through the concept of "epistemic communities". The term was actually introduced by J. G. Ruggie in 1975, who described epistemic communities as

"... consisting of interrelated roles which grow up around an episteme, as a dominant way of looking at social reality, a set of shared symbols and references, mutual expectations and a mutual predictability of intention."<sup>77</sup>

P. Haas describes epistemic communities as follows:

"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."<sup>78</sup>

A basis for their action has to be found in the so-called consensual knowledge, which E. Haas defines as "a body of beliefs... that is widely accepted by the relevant actors, irrespective of the absolute or final 'truth' of these beliefs"<sup>79</sup>

Neo-Functionalists see the international setting as being complex, with a high

level of uncertainty and a range of internationalized issues. In order to comprehend issue-linkages and to formulate adequate policies, the state (as one among the main type of actors) must turn to groups of professionals - epistemic communities. The distinguishing features of these groups include: a shared set of causal and principled beliefs, a consensual knowledge base, and a common policy enterprise. E. Kapstein exemplifies this by the 1987 bilateral agreement between the US and Britain, regarding capital adequacy standards.<sup>80</sup> Shared causal beliefs relate to understanding that confidence in international banking was eroded by the debt crisis, and a global run on the banks could require significant central bank interventions. Shared principled beliefs were that, as the international trade and payments systems were a collective good, central banks must ensure the safety and soundness of the systems. A common policy enterprise, that combined both these beliefs and the banks' interests, concerned the development of a single capital adequacy standard that would strengthen the system and restore confidence. In this way, the bankers' community would provide adequate knowledge and the course for state action.

However, this perspective was criticised as being too idealistic and normative. It is said that Functionalists neglect existing modes of international organization, and bring back in the high-politics / low-politics distinction. Furthermore, they seem to underestimate the significance of sectoral spillover. On the other side, this perspective seems to overestimate an "apolitical" will and desire of social groups to avoid conflict and pursue cooperation.<sup>81</sup>

#### **5.2.4. The Globalist perspective**

The last among the main perspectives on international relations is the so-called Global Politics approach, although it is also often termed "Pluralism", "Transnationalism and Interdependence", "Issue-paradigm", etc. It is widely accepted that this perspective offers a more general approach for it tends to combine certain assumptions and conclusions from each of the three perspectives described above. It has been developed as a main challenge to Realism, presenting the other ideal type of the global system. In doing so, it has successfully incorporated some of the findings of Structuralism and of Functionalism as well, for the purpose of constructing a more appropriate and reliable framework for analyzing world reality. Although the perspective was being most actively developed during the 1970s, it still attracts numerous writers.<sup>82</sup> Key words are interdependence, transnationalism, issues, linkages, multicentric world and global management.

The Global Politics approach is seen as a way of better comprehending the reality that cannot "fit" into the three conventional perspectives described before. D. Puchala calls for a new conceptualization in the theory of international relations.



"No model describes the integration phenomenon with complete accuracy because all the models present images of what integration could be or should be rather than what is here and now... Clearly, to surmount the conceptual confusion we must set aside the old models, and ... we must create a new, more appropriate, more productive analytical framework."<sup>83</sup>

So, in order to examine and study reality properly, one must not insist on the conservation of existing theoretical "tools", but must develop alternative (new) frameworks when necessary. The Globalist approach aims exactly at that.

Recent decades have witnessed dramatic changes in all aspects of social life: communications and contacts within and between societies have been improved, market operations have become globalized, integration tendencies strengthened but on the basis of simultaneous centripetal and centrifugal forces. A more detailed survey of transformations in the financial sphere was presented in the first part of this analysis. Moreover, demarcation lines between various political problems (domestic / foreign / global; economic / military / social), as well as between various political actors (governments / private actors; domestic / international / global) have become blurred. All this has led to a polyarchical (or multicentric) global structure, with numerous and different participants, issues and processes closely intertwined. Oversimplified, this kind of the world environment is the foundation from which the Global Politics analysis originates.

Basic conceptual blocks in this approach are complex interdependence (as opposed to state independence), transnationalism (as opposed to internationalism, or inter-state relations), and transgovernmental relations (as opposed to the coherence and unity of the state apparatus).

Keohane and Nye have offered the concept of complex interdependence, as the most suitable analytical device to explain changes and processes in the world of today.

"In common parlance, dependence means a state of being determined or significantly affected by external forces. Interdependence in world politics refers to situations characterized by reciprocal effects among countries or among actors in different countries."<sup>84</sup>

Moreover, when these effects emerge in an environment wherein the connecting channels are multiplied and diversified, where political questions are not hierarchically arranged, and where military force is of a lesser importance and usage, the world is characterized by complex interdependence.

The second conceptualizing block is the expansion and proliferation of transnational relations, as exchanges that are carried out across state boundaries and usually away from the government control. Keohane and Nye define transnational relations as including cross-border interactions, in the fields of communication, transportation, production and finance, and travel, as well as transnational organizations. The latter is described by J. Rosenau (1990) as sovereignty-free

actors (multinational corporations, ethnic groups, bureaucratic agencies, political parties, religious organizations, associations, etc.), in contrast to sovereignty-bound actors (states). The emergence of transnational actors in world politics have had a profound effect in many aspects: in interstate politics, in perceptions of power, loyalty, national and private goals, in international organization, and so forth. K. Skjelsback<sup>85</sup> describes transnational organizations as institutionalized cross-border interactions, where there is a high intensity of interactions and central coordination is needed. "Institutionalization tends to follow multilateralization" (Skjelsback) when there is a shared belief that potential emergencies (crises) might require joint operation.

Developed in this way, a global organization would result in a particular non-governmental (NGO) world as a counterpart to the existing, but declining world of states. The advent of the multi-centric world is the result of global processes, including the emergence of new political issues and new institutions, an authority and legitimacy crisis of state-actors; and growth of subgroupism and transnationalism.

"The universe of global politics had come to consist of two interactive worlds with overlapping memberships: a multi-centric world of diverse, relatively equal actors, and a state-centric world in which national actors are still primary. The norms governing the conduct of politics in the multi-centric world have evolved so as to diminish the utility of force... An autonomy dilemma serves as the driving force of the multi-centric world."<sup>86</sup> Rosenau<sup>87</sup> develops further this concept of the two, mutually not exclusive, worlds by comparing their basic structures and processes. The principal goals of actors in the state-centric world relate to the preservation of territorial security and integrity, while those of the multi-centric world are the increase of the world market share and the integration of subsystems. If a conflict arises, actors in the state-centric world resort to armed force, while actors in the other world withhold (withdraw) from cooperation and compliance processes. According to the modes of collaboration, the state-centric world relies on formal alliances, whereas actors in the multi-centric world usually form temporary coalitions. The hierarchical order in the state-centric world is contrasted to a relative equality among actors in the multi-centric world. The state-centric world is less inclined to changes, while the other is highly flexible and adaptable, with diffused control over outcomes. Finally, these two global orders are not mutually exclusive, and each seek to exercise influence on the other. For the time being, the autonomy of the state-centric world has not been seriously undermined. Furthermore, the sovereignty-bound actors increasingly turn to develop active relations with the multi-centric world.

"Sovereignty-bound actors (SBAs) yield jurisdiction, fully or partially, to transnational sovereignty-free actors when [inter alia] an issue has acquired such momentum in a particular direction that to attempt to curb the

involvement of sovereignty-free actors is to risk unacceptable consequences in other policy areas. SBAs coordinate with other states as a means of moving freely in the multi-centric world when [inter alia] transnational interactions among sovereignty-free actors begin to impinge upon the stability of two or more governments."<sup>88</sup>

Finally, the third conceptual block in Global Politics is the existence of particular relations between government agencies and departments with similar entities in other countries. In 1973, S. Huntington wrote about the rising importance of transnational organizations in world politics<sup>89</sup>, but Keohane and Nye were the first to use the term "transgovernmental relations".

"We define transgovernmental relations as sets of direct interactions among subunits of different governments that are not controlled or closely guided by the policies of the cabinets or chief executives of those governments."<sup>90</sup> This is the most important contrast developed in relation to the Realist perspective, which regards the state as a homogeneous actor that rationally pursues a coherent set of national goals. Originating from the work of G. T. Allison<sup>91</sup>, Keohane and Nye developed the idea that the state is not a coherent entity speaking with one voice. On the contrary, as the state consists of different bureaucracies with their own goals, policy analysis must focus on bureaucratic contacts below the top levels. As it is often the case, each of them may have a different perspective and calculus on a particular political question. From the outside, this may lead to a confusion, as different signals are sent out to other participants in the political process. In order to reach their own goals, bureaucratic structures often create relations and links to corresponding structures abroad.

Transgovernmental behaviour can take the form of policy coordination or transgovernmental coalition building. The former occurs when transgovernmental relations are designed to facilitate policy implementation or adjustment. The latter is built when bureaucratic structures from different countries come to share similar goals and join efforts to influence the governments concerned. Such transgovernmental relations are most easily developed through direct, but rather informal, contacts among working level officials in various international organizations.

As it is obvious, Global Politics derives certain theoretical postulates from the other three paradigms. From Realism, it accepts the existence of states and boundaries, as well as the predominance of hierarchical structuring of the world order (from the top to bottom).

The influence of Structuralism relates to the treatment of the state as not being an independent actor (decision-maker), but being affected by other actors. The emphasis laid upon economic issues and upon growing transnational relations is also shared with Structuralism, as well as the inclusion of conflict and interlinking of different political questions. Also, the analysis of the notion of power partially

resembles Structuralists' conclusions: power is not a fixed attribute exclusively based upon military strength of the state. It is neither a universal sort of "might" that can be an equally successful weapon in all political matters. Globalists see power from two aspects: it can be viewed as actual capabilities, but it can be also perceived as the influence over outcomes. It is exactly the political process that intermediates between the two aspects. Moreover, power resources specific to certain issues (matters) have to be considered as the most important.

From Functionalism, it accepts the group-based approach and the existence of cooperation (not just conflicts). From both Neo-Realism and Functionalism, it accepts the assumption that the sectoral approach is the most applicable to current world politics. Simplified, the global political system is not a single phenomenon, but it rather incorporates a number of systems (subsystems) formed around certain sets of political questions (issues) seen as being interrelated. Participating actors vary in regard to their nature and type, but they all engage in contention over stakes they perceive important for their own values and interests. This particular feature of the Global Politics perspective has invoked the use of an alternative label - "the issue-based paradigm". As it is related to the regime theory (which will be overviewed in the following section), this concept needs more clarification.

#### **5.2.5. The concept of issues**

Particular historical events and developments attract intense "political" attention from a great number of actors on the world scene, sometimes due to the wide impact invoked, sometimes for the radical structural changes resulting therefrom. The Cold-War is often seen as the predominant historical development in the post-war era that was embracing a number of interrelated questions, and which was paid an attention incomparable to other developments occurring at the same time. The same applies to the decolonisation process, and more recently, to environmental problems, development, debt crisis, etc. From the theoretical point of view, it is still not clear what the nature of the process has been, that has allowed a particular clustering of political questions, or specific arrangements (groupings) among and between political actors to emerge. By the same token, theoretical dilemmæ still exist in relation to motivation underlying political actions, in relation to the nature of political processes initiated, in relation to the existence and development of linkages between political actors and political choices, etc. Simultaneously, it is still a matter of theoretical dispute how those sets of political questions invoke (translate into) concrete policy responses and actions.

"All research questions in the study of international relations can be formulated in terms of the researcher's desire to understand the inputs to

political processes, the structures within which politics occurs or the outputs from political processes. The inputs are the attempts by political actors to mobilise support... The structures are the political actors, the groups they form and the communication channels between them. The outputs are collective policy decisions."<sup>92</sup>

The concept of issues aims at surmounting: 1) concrete, power-related simplifications of Realism; 2) idealistic, conflict-ignoring simplifications of Functionalism, and 3) deterministic, polarizing simplifications on economic grounds, of Structuralism.

As the example of the petrodollars and Iranians from the first section of this chapter has demonstrated, these simplifications cannot contribute to a better comprehending of reality. In that particular case, it was not the military power of the US vis-a-vis Iran that brought the crisis to the end. Far more, it was not a cooperation of major financial groups and experts (primarily from the US, Saudi Arabia and Iran) that sat together and joined the efforts to avoid (resolve) the crisis for the welfare benefit of the countries concerned. Finally, it is not clear who was the exploiter and where was the demarcation line between the centre and the periphery, keeping in mind that the money from the Middle East was actually fuelling the US economy.

Although that example does not represent "an issue" from the theoretical stand (it was too specific, concrete and temporary), it was chosen to point out how a particular pattern of events (political choices) may cut across several broad sets of questions - issues, such as security, human rights and efficiency. It was the perceived threat to the security of the US (firstly, as an economic threat) that actually put in force the Trade with the Enemy Act. At the same time, the issue of human rights was also "tackled", regarding the hostage seizure and financial sanctions imposed on Iran. Simultaneously, the issue of efficiency (benefits from foreign accumulation) and the issue of freedom (unrestricted but safe cross-border capital flows) were impinged upon. All this could be also regarded from a different perspective, as these issues combine into more general, "hyper-issues" of security, justice, equality, welfare, peace, etc. The involvement of so many different actors in the concrete example (the US State department, the Treasury, the Senate, major US banks, the Iranian government, government-mediators, governments hosting foreign branches of US banks, the Gulf families, foreign banks, etc.) brought in a range of different and sometimes conflicting interests.

For example, foreign banks, US banks with no Arab deposits and the Iranian government took the same position regarding a particular stake of interest on frozen Iranian assets. They were pressing for large US banks to pay the interest, for they were actually using these resources for free (during the freeze). Foreign banks saw this as a matter of equality on the global capital market, but also as a matter of efficiency because of the eventual continuation of business with Iran. The US banks

regarded the stake as undermining the equality of institutions within the US financial system. The Iranian government considered this as impinging on the issue of (economic) security and of freedom. Starting from these different perspectives, these actors actually made an informal alliance to reach the goal: payment of interest by the US banks that were using the assets.

The issue-based approach to international relations emphasizes groups as political actors (versus states as major political actors) and the system of values (not power) as underlying grounds for political actions. A group of people enters a political process when it perceives certain questions as being relevant for the realization of its goals and values underlying them (Willetts, 1990 and 1992). They interact with other groups in order to mobilise support that would uphold their position (view, attitude, approach) in relation to the questions. In order to facilitate communication between the actors, specific organizational structures are created. This brief explanation of the issue-based paradigm can be further decomposed into a few important elements.

Concerning the actors that enter political processes, they can be of different types: governmental, non-governmental (both domestic and international), quasi non-governmental, etc.<sup>93</sup> They are also considered to be interdependent actors, for the actions of each of them would eventually affect (to a lower or higher degree) other actors' behaviour. If one assumes that states are just one type of actor in global politics, more consideration has to be given to the emergence of political actors in general. Mansbach and Vasquez studied the process of development and decay of political actors and have subsequently offered a particular actor-emergence model.

"The formation of a political actor occurs as a two-step process. The first is the decision among the deprived (potential members) to communicate with one another about the prospects of forming a group, and the second is the actual formation of an actor from among potential members."<sup>94</sup>

The status of an actor is a result of the actor's size, development, available resources and needs. Mansbach and Vasquez argue<sup>95</sup> that, concerning potential members of an actor, their status will condition the degree to which they feel value deprivation. The status will also shape their attitudes towards politics, those ranging from apolitical, antipolitical attitudes, to more active and participative attitudes. Finally, the status will define the availability of stakes that can be used to alleviate value deprivation. If communication occurs among potential group members, it can contribute to the growth of a sense of mutual relevance. This is exactly the political participation that can be eased or made more difficult depending on the organizational context. The actor's access to communication channels will crucially affect its position and the extent of possible support it can obtain. Finally, if the level of potential members' interdependence and similarity is adequately high, they will join to form a political actor.

"Actor formation will take place only among those who perceive that they

have something to 'offer' one another which 'links their fates', and only if it appears that their joint contribution will aggregate sufficient resources so that there is a possibility of ameliorating their joint condition."<sup>96</sup>

So, what is actually in focus in the issue-based paradigm is how and why political actors perceive certain questions as being of a high importance for the realization (preservation) of their values. Usually, these final ends are considered to be highly abstract, because they symbolize general aspirations and are subjectively constructed. Therefore, the contention among political actors occurs over stakes, regarded as being instrumental for achieving abstract values. Sometimes, however, stakes can be abstract as well, if they relate to the actor's status or a general, desirable behaviour.

P. Willetts offers a four-level analysis of this concept. For a single actor, perceived relatedness of political stakes forms an issue.

"A political stake is a specific item of material or abstract value that has to be allocated by choice between two or more alternatives for social action. An issue consists of a set of political stakes that are perceived to be related to each other, by their each being salient for the realisation of the same value, in a specific situation."<sup>97</sup>

At a higher level of analysis, a group of actors forms an issue-system when they engage in

"... contention over proposals for the disposition of stakes that each actor perceives as being salient to the same issue."<sup>98</sup>

Different issues can be aggregated to form an issue-dimension, if they are relevant for achieving the same value. If two or more dimensions seem related, for the underlying values belong within the same ideological framework that makes them interdependent - a hyper issue can be outlined. Accordingly, a wider issue-system encompasses a number of issues from the same dimension and a number of actors contending for the simultaneous disposition of stakes from these issues. Finally, contention among actors over proposals to sustain (back) a particular ideological framework (necessary for linking the values from different dimensions) forms a hyper-issue system. However, these analytical levels are theoretical constructs that are not easily recognized and "justified" in reality. Perceptions, ideas and actions, as well as the actors themselves, cannot be divided by clear demarcation lines. Actors often engage in political processes regarding numerous and different issues and stakes, and a position and attitude taken towards one of them may well affect their stand on the rest of the matters. In the multi-centric world of today, these aggregations and interactions occur in a way rather different from those in the state-centric world. J. Rosenau underscores reciprocity as the central mode of the processes in the state-centric world, which is not the case in the multi-centric world.

"In this world of complex issues, overlapping agendas, diffuse authority structures, and a shared right to initiate action, the actions of A directed to

B as often produce reactions by C directed to D as they do reactions by B. Thus, developments ... move forward in an asymmetrical, crazy-quilt fashion, with the sequences of action being propelled from one system to another and from subsystems to other subsystems in the same and different whole systems."<sup>99</sup>

The aggregation of stakes and issues towards higher levels may be carried out in different ways. Sometimes, actors seek to achieve the same value, or at least perceive their goals as being based on a same single value. Sometimes, linkage of issues may be the result of the organizational context of a political process. As it was mentioned, the organization can facilitate the access to communication channels through which political actors express themselves and seek support. Many international organizations (both governmental and non-governmental) do not have a very limited agenda - they are concerned with a range of more or less related matters. Under these conditions, participating actors can link issues by bargaining, making concessions and compromising. Another type of linkage called "an actor linkage" can be developed if an actor's membership in the political system comes under question. The third type of linkage, a functional linkage, occurs when actions regarding different issues are interdependent: actions taken on one issue will necessarily affect actions on the others. The importance of these linkages will be highlighted later, when the analysis shifts to policy systems.

So, the Issue-based paradigm should provide new analytical tools that differ (to a greater or lesser extent) from the frameworks offered by Realism, Functionalism and Structuralism. The Issue-based paradigm, with a permanent danger of oversimplification, could be exemplified as follows.

Among other hyper-issues, such as human rights, conservation and development, a particular occurrence on the world-wide scale is the emergence of the global economy. Global integration was evident as early as the 1960s, but during the 1970s and 1980s this proved to be more than just a phase in world economic life. It has embraced a variety of developments, it has impinged upon almost all aspects of social life, it has created wide opportunities and even wider problems. So, the hyper-issue of global economy seems to consist of a number of issue-dimensions, like the dimension of honesty/justice, the dimension of welfare, the dimension of equality, etc. A range of different issues can be clustered within each of the dimensions, according to the same underlying value. The issues of (economic) security, fraud and money laundering are all relevant for the realization of the same abstract value - justice. From another dimension, the issue of efficiency and the issue of freedom v. order are both salient for achieving the value of welfare. Yet from another dimension, the issue of humanitarian warfare, the issue of aid and alike seem all interrelated for reaching the value of equality. Each of these issue-dimensions are also related to each other for the underlying values are perceived to be complementary and interdependent within the ideological framework of a global,



capitalist market economy. There can be no justice where there is no equality. To achieve the value of welfare it is necessary to provide security in all its aspects.

Each of the mentioned issues consists of a set of political stakes that are under contention by groups of actors. For example, the issue of freedom v. order comprises a number of stakes such as: international/global economic coordination and cooperation, transborder supervision and control, information disclosure, harmonization of regulation, etc. Concrete stakes under contention within this issue-system are numerous and include, inter alia, consolidated supervision of multinational banks, reciprocal treatment of foreign banks, etc. The issue of efficiency might be considered to consist of political questions regarding the financial flows, global production, transfer of technology, etc. Again, there is a range of concrete stakes involved, like overexposure and capital adequacy of multinational banks, internationalization of domestic markets and its impact on national financial efficiency, etc. Some of these stakes will be examined in more detail in Chapter Seven.

There are all sorts of political actors involved in dealing with these issues, some of which will be analyzed in the next chapter. Their attitudes and actions quite often overlap, due to existing linkages. For example, efforts to combat money laundering and to prevent fraud may be pursued by different actors, clearly linked for the realization of the same value - the value of justice. Debt-for-nature swaps, as a method of easing the debt burden of the Third World, are the examples of bargaining linkages. Outside the hyper-issue of global economy, an actor linkage is best exemplified by the "disputed" status of the PLO in international organizations such as the IMF. Finally, functional linkages are most widespread among the issues mentioned above. Debates around the issue of security (for example, the extent of financial safety nets for banks) have a direct impact on political controversies about the efficiency of banks or their freedom to operate.

The importance of issue-linkages is highlighted when it comes to the translation of aspirations (values) into more specific actions in the world of reality. As it was mentioned, issues are formed when political actors contend over the disposition of stakes, which are important for the realisation of the same single value. Actors enter communication channels to mobilise support for their position on issues, i.e. they enter organizational structures in order to influence the course of action (policy) regarding political alternatives under dispute.

"A regular process within an organisation of taking decisions that are seen as being related is known as policy formulation."<sup>100</sup>

Functional issue-linkages contribute towards "grouping" two or more issues into the set of political questions that are going to be dealt with collectively. When these linkages are not direct or immediate (e.g. the link between a cut in national interest rates and a reform of the country's stock exchange system), they will eventually affect the outcome through the policy system which is

"... a group of actors in contention over proposals for the resolution of political questions that each actor perceives as being necessary for achievement of its own specific objective."<sup>101</sup>

When two or more policies seem functionally related to each other, a policy-system expands and becomes a wider-policy system. If functional linkages are not created, bargaining or actor linkages may aggregate broad policies (functionally interrelated policies) into policy-packages. At this highest level, several sets of policies have to be negotiated simultaneously. Recalling the earlier example of the global economy, the highest level would present the policy-package for the global capital flows. On the one hand, a broad policy would aim at maintaining supervision and control over and beyond state borders. It would encompass a number of policies functionally interrelated: the policy towards risk-taking, the transparency policy, the policy for harmonization of regulatory supervision, the policy for money-laundering and fraud, etc. On the other hand, a second broad policy package would encompass all policy all directed to efficiency promotion: the liberalization policy, the policy towards deregulation, the technology policy, etc. The policies from each of the broad aspects seem to be interrelated. For example, the policy towards harmonization of the regulation of capital flows can "confront" the policy towards financial deregulation, and only through bargaining and compromising between national regulators can this confrontation be surmounted. The policies within these two broad policies seem to be even more related, but on the functional basis: the policy to fight fraud and money-laundering heavily depends on the transparency policy (e.g. detailed information disclosure on a consolidated basis). Further down, the transparency policy embraces a number of functionally related political questions (choices), regarding how detailed the disclosure should be, how to structure organizations responsible for processing these disclosures, etc. All other policies also consist of numerous political choices for specific actions.

For a group of actors, a policy-system includes actors and their contention to resolve political questions they perceive salient for their goals (objectives). A wider policy-system emerges when actors contend over the distribution of stakes from two or more different, but related, policies (Willetts, 1992). For example, the transparency policy-system includes banks, securities houses, financial funds, clearing and settlement organizations (on both the national and the international level), financial associations (on both the national and the international level), different national regulators (e.g. finance ministries and independent government agencies), regulatory commissions of international governmental organizations (like EC and OECD), and independent agencies and institutions (like the Group of Thirty and the Institute of International Finance). The transparency policy-system also includes, besides actors, all their relations and interactions, as well as policy outcomes of these processes. The transparency policy-system may be regarded as being a part of the wider policy-system of supervision and control. Banks, for

example, enter into contention over the concrete stake of the level of detail in information disclosure for several simultaneous purposes. This may be directed, among other purposes, towards risk-prevention, enhancement of market transparency and the fight against money-laundering.

It is still a matter of theoretical uncertainty what is the mechanism that mediates between the ideological / perceptual sphere of "issues" and the teleological / behavioral sphere of "policy". One approach is offered by M. Bentham, in her work on the policy responses to drug-trafficking.<sup>102</sup> She develops the idea that the existence of norms provides the translation of issue-systems into policy-systems. Norms are described as durable patterns of behaviour, enforceable by authority but inferior to values.

"Norms can be seen to come into existence because there is a high level of consensus over the values that the actors share. The conflict over values can be seen to form an issue-system of actors for whom the issue is salient, but no norm and therefore no regime is possible. But once we have elected to have our actions governed by recognized principles, we have abandoned values for norms."<sup>103</sup>

It seems contradictory, at this stage of the analysis, that norms cannot emerge if the values are contested. For example, the priorities of banks and regulators can appear to be in collision to a significant degree, probably due to a different ordering of values to be achieved (preserved). Nevertheless, that was not the obstacle for certain arrangements to emerge in the field of banking regulation. More attention to this values - norms question will be paid in the following section. However, this points to the course of further analysis: there is a need to explain what intervenes between conceptions and actual behaviour (policy).

### **5.3. Regime theory**

Academic interest in the concept and theories of "international regimes" began to rise in the mid 70s. At that time, it was obvious that the predominant theories and approaches to the study of international relations had already proved to be incapable of explaining undergoing changes. The Realist approach was unable to explain the increasingly complex and interdependent world. The Realist approach is based on the assumptions that states are coherent units and that they act independently in order to maximize their power, within an anarchic environment. Similarly, there was the inability of studies of formal international organizations to explain "new" forms of international cooperation. According to those studies, international organizations are established for the purpose of "making order" in an anarchic environment, membership in those organizations is limited, their structure

is highly institutionalized and formal. In addition, some particular disturbances that occurred in the first half of the 70s (oil shocks, the flood of petro-dollars, debt failures, attempts to coordinate monetary policy, etc.) were clear signs that neither of the mentioned approaches was so useful any more. These limitations might be seen as the origins regime theories.

### 5.3.1. General approaches

Three main approaches can be identified, following S. Krasner's classification of writers<sup>104</sup>, concerning the theories of international regimes.

Firstly, under the label "conventional structuralism" (corresponding to classical realism) authors like Susan Strange do not accept the concept of regimes as being anything new or particularly useful and long lasting.

"That concern with regime formation and breakdown is very much an America academic fashion...The current fashion for regimes arises...from certain somewhat subjective perceptions in many American minds. One such perception was that a number of external shocks... had accelerated a serious decline in American power. A second subjective perception was that there was some sort of mystery about the uneven performance and predicament of international organizations."<sup>105</sup>

Theories of regimes are criticized as being too static and still state-centred, imprecise and value-biased, particularly underemphasizing domestic roots of international arrangements. They are seen as academic creations to show how, under declining-hegemony, arrangements could be made to minimize increasing damage and costs.

Secondly, under the label "the Grotian approach", authors like D.Puchala, R.Hopkins and O.Young, point out that regimes have always existed in every important issue-area in international relations where a patterned behaviour can be identified.

"Whenever there is a regularity in behaviour some kinds of principles, norms or rules must exist to account for it. Such patterned behaviour may reflect the dominance of a powerful actor or oligarchy rather than voluntary consensus among participants. But a regime is present."<sup>106</sup>

Thirdly, a sort of an academic "compromise" can be found under the label "modified structuralism" (corresponding to the neo-realist approach), that has been adopted by most authors. Here the basic assumptions of the realist approach are accepted but with some limitations. States are still the dominant actors, but under certain (restrictive) conditions independent state actions cannot provide optimal outcomes. So, regimes may arise (i.e. states have to give up, to a certain degree,

independent policies) when they have to cooperate for either of the two purposes: a) to ensure a particular outcome (pursuit of common interests, e.g. improvement of global trade flows), or b) to prevent a particular outcome (avoidance of common aversions, e.g. International Civil Aviation Organization, avoidance air-traffic collisions).

"The dilemma of common interest occurs when there is only one equilibrium that is deficient for the involved actors...In order to solve such dilemmas and assure the Pareto-optimal outcome, the parties must collaborate...By contrast, regimes intended to deal with the dilemma of common aversions need only facilitate coordination. Such situations have multiple equilibria, and these regimes must assure neither a particular outcome nor a compliance with any particular course of action, for they are created only to ensure that particular outcomes to be avoided."<sup>107</sup>

Although it has been perceived that these three general approaches differ in basic assumptions, it is clear that all the three have the "state" as a starting point and they analyze mainly inter-state relations. But if the classic Realist approach is left aside, regime theories can offer a broad range of variations, covering definitions, explanations for regime formation, basic characteristics and types of regimes. In order to illustrate various regime theories, this section will summarize the main ideas about regimes.

### **5.3.2. Definitions**

Most of the authors that study regimes tend to offer their "own" definition of a regime, describing the nature and origins of regimes or just marking different accents onto existing definitions. The definitions can be broadly divided into two categories: more general descriptions of regime nature and origins, and rather elaborated definitions, including regime nature, purpose(s), basic variables, etc.

Among the former, various authors identify regimes in various ways: with any regularity in behaviour (Puchala/Hopkins); with a set of principles and norms in a given area (Krasner); E.Haas describes regimes as artificial creations for making order; while Keohane and Nye refer to them as multilateral agreements among states. Some writers identify regimes as a mode of international governance in the absence of a supranational government in a given issue-system. For them, regimes are the most prominent manifestation of collective self-regulation, described as

"the voluntary participation by states and other international actors in collective action to achieve joint gains or to avoid joint losses in conflictual or problematic social situations."<sup>108</sup>

Among the latter group of explanations, regimes are defined as mutually coherent sets of principles, rules and norms (accent on the regime's nature), or alternatively, as man-made arrangements for managing conflict in a setting of interdependence, to introduce particular orderings of values among parties (accent on the regime's origins and purposes).

O. Young describes regimes as social institutions that govern the actions of those interested in specifiable activities. From the similar point of view, J. Ruggie explains regimes as a particular level of institutionalization, where a collective response is needed to a collective situation.<sup>109</sup>

From the complex interdependence "starting point", Keohane and Nye describe regimes as recognized patterns of practice that define the rules of the game. Keohane defines regimes as contracts that involve actors with long-term objectives, who seek to structure their relationship in a stable and mutually beneficial way.

Finally, one of the most frequently quoted definitions is Krasner's:

"International regimes are defined as principles, norms, rules and decision-making procedures around which actors' expectations converge in a given issue area."<sup>110</sup>

He refers to principles as beliefs of fact and causation; norms as standards of behaviour, including rights and obligations; rules as specific prescriptions or proscriptions for actions, and decision-making procedures as prevailing practices in achieving and implementing collective decisions. As much as this definition has provided inspiration, it has also provoked much dispute, particularly concerning the explanations of "principles" and "norms" and their relations to "values". This is especially important, because the linkage between issue-systems and policy-systems is crucially dependent on the values-norms relationship.

The study of values is basically a philosophical one, and perhaps that is the reason why it has attracted so little attention among writers on international relations. The value, as a philosophical notion, belongs to the field of axiology or, more precisely, to axiological ethics. The latter is defined as the branch of philosophy (ethics) dealing primarily with the relative goodness or value of the motives and end of any action.<sup>111</sup> An in-depth study of the philosophical writings on the notion of value goes far beyond the scope of this analysis, but certain theoretical findings are very instructive for regime theory. Theorizing about values in international relations cannot yield results unless it is based upon the original analytic roots.

For I. Kant, a value is a socio-cultural fact, which has its origin in the process of human self-reflection about the conditions of validity, conditions of authenticity of knowledge and legitimacy of action.<sup>112</sup> F. Hegel goes further and develops the idea of the "objective mind", which relates to the process of making rationally-structured human communities. The rationality of life in a community is possible only after morality, based on general and necessary principles of the

subjective mind, is objectified as the mind system (order). So, all social institutions, such as the state, law, religion, are forms of this objective mind or mind order.<sup>113</sup> These are the "classical" origins of many controversies about the nature of values. On one hand, values can be seen as deriving from social and psychological characteristics of human life (needs, interests, intentions, wishes, feelings, etc.). These are the so-called heteronomous values. On the other hand, it is argued that values are independent, subjective expressions of the reality, derived from the content of the individual consciousness. These are the autonomous values, represented in an ever-lasting human struggle for freedom and self-determination. The two groups of values are seen as being in a constant conflict, for the heteronomous values accentuate the society (the community), and the autonomous values emphasise the individual. Accordingly, there are two types of choices: choices imposed by the social context, and autonomous choices.<sup>114</sup>

The heteronomous values are social norms that describe/prescribe what is desirable and what should be desired. The heteronomous values regulate satisfaction impulses in accordance with: 1) the order requirements of socio-cultural systems, and 2) the requirements for respecting other people's interests and the interests of the group (the society) as a whole.<sup>115</sup> Understood in this way, values are needs, interests, feelings, preferences, motives and dispositions that originate from the motivational systems formed within the societies. So, values regulate desirable behaviour, to bring the individual's choice in accord with options that are useful to society. By the same token, values belong within the relational sphere and not to any object or subject.

"Heteronomous values are social norms that regulate relations between the individual and production, nature, other individuals, ... in a way that a widely-desired general behavioural orientation is reached."<sup>116</sup>

Even for K. Marx, the value is the relationship formed in the market between the seller and the buyer, in respect of the commodity that is traded. The two sides enter this relationship in order to come to an agreement upon the (quantity of the) value, each with their own system of valuation, preferences, motives, etc.

Later in the 19th century, basically in the Neo-Kantian tradition, and in the 20th century<sup>117</sup>, theories of value were further developed. It was argued that the whole (the world complexity) consisted of two parts: the factual part, and the part based on values that might be social values and universal values. C. S. Pierce and J. Dewey<sup>118</sup> explain the essence of values in the pragmatic tradition, as making the choice between alternative goals, so that the most beneficial consequences are yielded. In this tradition, F. Kratochwill explains norms as bridges between ill-informed actors, in their search for common problem solution.

"Interacting parties can often neither rely on a common history nor expect future gains through the use of tit-for-tat strategies. Precisely for that reason, it is the function of norms to fortify socially optimal solutions, against the

temptations of individually rational defections."<sup>119</sup>

The analytical approach in axiology underscores the importance of linguistic structures, used to express preferences, decisions and choices of participants in the process of social communication. This intra-community communication leads to the development of universally-held values.

A particular theoretical problem is how to relate values and facts to the world of reality, or how to derive "ought" from "is". According to J. R. Searle<sup>120</sup>, the link is the existence of "institutions" and "institutional facts". The latter is interpreted as basic facts that appear in a certain context (an institution), with constitutive rules concerning its functioning. From this perspective, the basic institutional fact is the language. This approach was recently further developed by F. Kratochwill, with his idea of the existence of three parallel worlds: the world of observational facts, the world of intentions and the world of institutional facts.<sup>121</sup>

This excursion into the field of philosophy was necessary in order to illustrate a variety of theoretical approaches and findings about values. However, it is evident that most of the writers neither strictly separate values and norms, nor confront them. It has to be mentioned, though, that axiological analysis very rarely enters the field of conflicting social choices and the practical efficiency of norms. It neither pays adequate attention to the difference between goals, interests and values, with respect to the different levels of abstraction and generalization. Related to this, axiological approaches do not offer an explanation how concrete stakes become instrumental for the realization of values. However, any theoretical analysis of values and its implementation within other scientific disciplines must at least "consult" philosophical theories.

A particularly useful insight, that is often neglected, relates to the importance of communication and language for widely-shared values to emerge. Apart from pure philosophical theories, values and norms are also widely analyzed in sociology, psychology and theories of law. For the course of this study, it is very instructive how theories of law analyze values and norms, although this literature has hardly ever been consulted by International Relations' writers.

Theories of values can be distinguished according to various criteria<sup>122</sup>, so values are sometimes ideas, independent of the social reality (Platonism, theology, phenomenology); values are also seen as the elements of the human nature (Aristotle, Kantianism, Naturalism), and values can be perceived as resulting from human activities (Nietzsche, pragmatism, Marxism, existentialism). A great number of particular values exists, such as: 1) socio-biological values (health, strength); 2) economic values (utility, profitability, economic stability); 3) scientific-educational values (truth, knowledge, objectivity); 4) religious values (sacredness, respectability); 5) political values (power, prestige, equality); 6) cultural values (beauty, creativity); 7) generic human values (freedom, love, rationality, dignity of life), and 8) values of social ordering. The last category is particularly important for



this study. Particular values of social ordering include morale, custom and legal values, and in their unity they provide disciplinary mechanisms for the society. Morale encompasses values of goodness, honesty, dignity, sincerity and loyalty. Custom values relate to different values, but usually cover sense of decency, respect for tradition, etc. Finally, legal values include values of justice, peace, safety and legality. Value of safety, as described by theories of law, is of a great importance for regime theories. Value of safety is described as the ideal of a total predictability of conditions and expectations related to social existence of individuals.

From this aspect, norms are seen as basic techniques of social ordering or of exercising control. They are means of the compulsory qualification of behaviour and of its directing - by limiting, stimulating or preventing certain types of behaviour. The main purpose of norms is to provide maintenance of the system from which they originate.<sup>123</sup> From the aspect of law theories, there are three parallel social orders: custom order, moral order and legal order, so there are also three basic types of norms - custom norms, moral norms and legal norms - that form durable expressions of social consciousness.

"Law does not perform a unique social function, nor is it a singular form of social control... Legal rules are only one of a number of systems of rules, often overlapping and entwined, which shape people's aspirations and actions."<sup>124</sup>

Sometimes, these types of social norms are seen as forming normative social consciousness, i.e. the overall comprehension that there are certain values that should be protected by normative regulation of social behaviour.<sup>125</sup> Normative consciousness becomes particularly important when the existing norms (most often, legal norms) fail to follow the development of social needs, new problems and situations. For every norm, it is essential that the particular requirement (contained in the norm) is built in a wider/higher system of requirements. The latter is, in turn, dependent on: a) the actually accepted or assumed value, or b) the efficiency of the whole system of requirements.<sup>126</sup>

In contrast, rules consist of no requirements. They are prescriptive expressions/instructions about actions or behaviour that should be taken if a beneficial effect is to be achieved, or if a harmful effect is to be avoided.

Sometimes, however, law and legal order do not keep the pace with overall social and economic development.

"Social processes including law seek to satisfy, above all, the psychological need for structure in people's lives... When society [state] fails to meet its members need for structure, law cannot achieve its immediate goal of promoting social cooperation."<sup>127</sup>

When this kind of social situation occurs, other means and ways of structuring and organizing become dominant forces of social dynamics. Different social groups are formed, both within and across boundaries of existing legal orders, and dynamics

of these processes brings forward another type of norms called "group norms".

Theoretical findings in the field of psychology of groups can significantly contribute to a better understanding how new forms of social organizing (including regimes as well) emerge and function.<sup>128</sup> From this aspect, the group is defined as a social unit of participants whose status and roles are specified, which has its own system of values and norms that regulates participants' behaviour regarding the matters salient to the group.<sup>129</sup> Factors underlying group formation include common goals, a feeling of group belongingness, the possibility of mutual influencing, and the existence of common norms. Group norms, often termed "group standards", regulate expected and typified behaviour of the group members. They also present a common acceptance of a prescription for perceiving, feeling, thinking and acting of the group members.<sup>130</sup> Functions of group norms include, inter alia, guidance for action to achieve the group goals, provide orientation for evaluating members' behaviour and for the decision-making, and coordinate activities for conservation/preservation of the group. Group processes encompass the creation and acceptance of norms, cooperation and competition, coalition formation, settlement of intra-group conflicts, and decision-making process. The fundamental force in the creation of group norms, which is of a great importance also for regime theories, is a gradual convergence of the members' opinions, views and attitudes regarding group-salient matters.

Having examined values and norms from such different aspects, the dispute in International Relations concerning the Krasner's categorization of the elements of regimes (principles, norms, rules and decision-making procedure), seems to be mostly exaggerated. It can be accepted that values can be viewed both as independent orientations and as socially-induced facts. Basic principles thus can be considered as forces (both autonomous and heteronomous) that "shape" values and norms. The relational nature of values is represented both through the existence of norms (in a broad, general context of a community or organization or a regime), and through rules and decision-making procedures (in a particular institutional context). Even more, the dispute over these four elements seems sometimes to be a form of over-theorizing ("l'art pour l'art"), for this approach has proved to be fairly instrumental and practically useful in analyzing international organization in the real world.

Defined either in a broad or in a more specific way, regimes have been criticized from the conventional structuralist approach.

"At one extreme, regimes are defined so broadly as to constitute either all international relations or all interactions within a given issue-area. Such use of the term regime does no more than signify a disaggregated issue-area approach to the study of international relations, and so defined "regimes" have no conceptual status...

At the other extreme, regimes are defined as international institutions. In this

sense, they equal the formal rules of behaviour specified by charters of such institutions...This formulation reduces the new international political economy to the old study of international organizations..."<sup>131</sup>

Just the contrary to this criticism, the usefulness of this broad range of definitions is directly derived from a Globalist "issue-area" approach (a multiplicity of actors, the relevance of norms, military power does not necessarily dominate, etc.) and from the "international institution/response" approach (differs from formal analysis of international organizations). They have proved to be analytically useful, as they attempt to bridge the gap between the Realist concepts of anarchy and formal organizations.

### **5.3.3. Regime formation**

Directly linked to this wide range of regime definitions, various explanations have been offered for regime formation. Generally, two basic approaches to the study of regime evolution (as well as to the study of any social phenomena) can be identified. First is the normative approach, usually recognized under the label "idealist". This kind of explanation mainly analyzes and specifies desirable regimes, i.e. how the world of international politics should be structured. For the purpose of this analysis it is more interesting to summarize the main achievements that belong to the second, empirical approach.

1) Economic explanations link regime creation to two main factors: technological change and changes in supply and demand. Accelerated technological developments (particularly in the field of telecommunications and informatics) have formed the basis for different regimes to emerge (e.g. INTELSAT regime in the mid 70s). Related to that, surplus capacity or any other form of continuing market imbalance may be responsible for regime creation in a certain area (e.g. the "over-developed" electrical appliance industry in the EC gave way to intra-European specialization in this field). But, as such explanations can be useful only if one assumes that there is an ideal, perfect competition (market operates perfectly with no significant government/political interference), additional factors have to be included in the analysis of regime formation.

2) Political explanations add to this more of the "state- reality" from the present world. If the model of perfect competition is a theoretical fiction (and it is), state policy, goals and instruments have also to be considered. Political explanations have been developed in two modes: the structural and the situational mode.

The structural mode of political explanation refers to power as a crucial variable for regime creation. From the Realist perspective it is a global, overall power structure that influences a regime formation. Neo-Realists, on the other hand,

consider issue-specific power, i.e. power capabilities in a particular issue-area as the most important impetus for a regime creation.<sup>132</sup>

Situational mode explanations are usually labelled as functional theories of regime creation and change. According to them, regimes evolve in situations described as dilemmas: actors involved have to make choices between incompatible alternatives that have both desirable and undesirable consequences.

"International politics scholars have pointed to the continual 'security dilemma' facing states in an anarchic international system: many of the means by which a state tries to increase its security decrease the security of others. Economic theories of market failure and the 'free-rider' problem in the provision of collective goods analyze dilemma situations among economic actors."<sup>133</sup>

Most of the mentioned explanations are essentially static: they take one or another factor as being crucial for regime formation, but without taking into the account changes of actors' goals and changes in their learning.

3) Cognitive explanations tend to overcome that static analytical framework. In addition to the factors already mentioned, they include the political process as a variable for regime creation. What is important is interaction between changing knowledge and perceptions and changing social goals. This particular kind of process is carried out through multilevel bargaining and on the basis of complex transnational and transgovernmental networks of relations among states. This kind of explanation is useful if the reality has been perceived as being one of "complex interdependence".<sup>134</sup>

To sum up, four different models can be marked out in explaining regime formation: an economic model, a structural model, a situational model and an international organization model. Accordingly, these explanations ask different questions for the study of regime evolution: a) what economic change leads to a regime's creation; b) what shifts in power create a new regime; c) which aspects of problem situations make governments choose collective action; and d) from what kinds of bargaining processes do agreements emerge?

It is worth pointing out that only the last model puts more emphasis on the power as the command over outcomes rather than the command over resources. It does so by introducing dynamics through which initial causal variables are transformed into organizationally dependent variables, as the results from bargaining processes.

### 5.3.4. Purposes and functions

Apart from the differences in regime definitions and in basic explanations about regime formation, it is clear that regimes are intervening structures (variables, in Krasner's words). This assertion needs to be clarified in more detail. Generally speaking, "intervening" relates to something occurring incidentally so as to modify or hinder the situation, or to something (legally) interposing and becoming a party to a suit pending between other parties. The attribute "intervening" may refer to the place that regimes occupy on the spectrum of international relations: they are created somewhere between the "sovereign-state" beginning and a "world-authority" end. The attribute also refers to the fact that regimes usually provide (if they are complied with) governance over the relations among participants in a given issue-system. The term "intervening" may also be related to the normative nature of regimes, which R. Keohane describes as being objectified by

"...a persistent and connected set of rules that defines behavioural roles, shapes activity and expectations, constrains the range of acceptable behaviour, and thus governs the relations among the participants."<sup>135</sup>

Krasner's use of the term "variable" may have several explanations as well. Firstly, there is a need to stress the changeable (alterable) nature of regimes, as well as their adaptability. Secondly, the term may well point to the "dual" perspective that has to be taken in respect of a regime's functioning: it can be viewed both as an independent and dependent variable. A regime can be analyzed as emerging from basic constants (then it is the dependent variable), but also as a mode of organization with "a life of its own" (e.g. the impact of secretariats, or the durability and resistance to change even after some basic inputs have been altered). Thirdly, it can be argued that the use of the term "variable" aims at emphasizing the situation (international anarchy, absence of a global government) where a regime can induce a change: a common goal can be reached, or certain conflicts avoided.<sup>136</sup>

As regimes have been defined in so many various ways, so have essential purposes and functions as well. It has been suggested that regimes are created to provide a form of international authority, in the absence of any "world government" or a higher-than-state level of authority. There has been an ongoing process described as "the internationalization of domestic authority relations".<sup>137</sup> From another point of view, regimes are created for the purpose of managing conflicts that might arise under conditions of interdependence. Regimes can provide cooperative behaviour through building frameworks, institutions, norms, etc.

In the same context, regimes are created for the purpose of achieving either collaboration or coordination. The main difference between these two types of cooperative behaviour is derived from the nature of the basic causal variable: the

collaboration requires joint efforts/work, while the coordination demands adaptation/synchronization of actions. If the actors have common interests they seek to realize, they need the collaboration with strict formalized behaviour (e.g. the SALT arrangements). If the actors have common aversions, the purpose of a regime might be to facilitate coordination where no international institutions are required (e.g. International Civil Aviation Organization).<sup>138</sup>

According to R.Keohane, regimes may be created (evolve) in order to facilitate important international agreements concerning particular problems.

"Regimes may be thought of as intermediary normative frameworks which facilitate the making of substantial agreements in a given issue-area."<sup>139</sup>

It has also been suggested that regimes may be created in order to reduce information and transaction costs, or to enable involved actors to acquire new capabilities, technologies, skills, etc.<sup>140</sup> Usually, the telecommunication and satellite regime under the INTELSAT is given as an illustration for these purposes. Under the leadership of the US, other countries have been given access to state-of-the-art telecommunication and satellite technologies; in turn, the US has been benefiting from the economies of scale, in using these expensive technologies.

Furthermore, regimes may be formed in order to reduce risk and uncertainty. This is particularly the case if there are serious disruptions in basic functions that the market has to perform: interlocative, interpersonal and intertemporal functions. A classical example of this kind of market imperfection is when sudden cuts in supply occur (e.g. of raw materials). But apart from the examples in the field of international economics, plenty of evidence for the importance of inadequate information flows can be found in all other areas of international relations where negotiating and bargaining is crucial.

"International regimes ... perform the function of reducing uncertainty and risk by linking discrete issues to one another and by improving the quantity and quality of information available to participants... International policy coordination and the development of international regimes depend not merely on interests and power, or on negotiating skills of diplomats, but also on expectations and information..."<sup>141</sup>

Also, regimes may evolve in order to facilitate sharing of burden (costs) that may arise in relation to market disruptions. The International Energy Agency was established in 1974, after the lessons from the first oil shock, for a particular purpose: member countries would contribute to the Agency, which would in turn, in the case of oil supply disruptions, help countries to overcome related financial problems.<sup>142</sup>

So, if any general comments can be made, it is clear that regimes are created mainly for the purpose of framing and structuring actors' relations in a way that they can communicate and cooperate effectively.

### 5.3.5. Conditions for regime formation

Throughout the literature, various (sets of) conditions have been suggested as being necessary, adequate or sufficient for a regime to be created. Globalists point out that regimes emerge when the interaction between the parties is not unconstrained or not based on independent decision-making. If the assumptions of an interdependent world are accepted, decisions concerning international relations are made under various constraints. In order to achieve a certain level of command over the environment that influences those decisions, actors may decide to create or enter an existing regime. Although actors are not able to carry out absolutely independent policies, they can still benefit from the relations organized via regimes.

On the other hand, Realists have been suggesting that the structure of power creates the conditions under which regimes will emerge. If the concentration of power (overall or issue-specific) is strong, the leader will tend to structure its environment through the creation of a regime according to its goals. The theory of hegemonic stability falls in this category: the stability and the maintenance of the Bretton Woods monetary regime until the 1970s was mainly related to an unquestionable hegemony of the US.

Keohane and Nye offered several conditions that would lead to regime formation. Higher probability for emergence of a regime is derived from the absence of any authoritative governmental institution and the presence of high uncertainty in a particular area. If there is a lack of a clear legal framework for actions, combined with information imperfections and positive transaction costs, governments will incline towards making international agreements. The demand for regimes increases according to a high issue-density (a great number and importance of issues in a policy area), and to a strong need for high quality information.<sup>143</sup>

More in the Realist tradition, Krasner describes the conditions for regime creation as those preceding an essential restructuring in power relations.

"Regime creation usually occurs at times of fundamental discontinuity in the international system, such as the conclusions of major wars..."<sup>144</sup>

From that point of view, the emergence of a new leader results from international conflict and this new leading state will push forward the creation of regimes (or transformation of existing ones) according to the new power structures.

J.Ruggie has suggested that regimes are created when a collective response is needed to a collective situation. He outlined this by four analytical dimensions: the degree of politicization, the type of policy interdependence, the loci of policy interdependence and the distribution of interdependencies.<sup>145</sup> So, when there is a high degree of politicization in particular issue-area, when there are various

contingencies and constraints, when the locus of interdependence is closer to domestic policy, then some sort of collective response will emerge, including regimes, epistemic communities and international organizations.

### 5.3.6. Common theoretical questions

Although regimes can be perceived in a number of different ways, it is possible to select a few characteristics that are more or less common to various regime theories. First of all, it has to be pointed out that regimes are, by their very nature, subjective, attitudinal phenomena. Puchala and Hopkins assign to them this feature because regimes "... exist primarily as participants' understandings, expectations or convictions about legitimate, appropriate or moral behaviour."<sup>146</sup> If regimes are described as intervening variables, their characteristics are derived from basic causal factors that had led to the regime's creation. Krasner identifies five basic causal variables: 1) egoistic self-interest (maximizing one's own utility), 2) political power (either to secure optimal outcomes or to enhance values of specific actors), 3) norms and principles (indirectly linked to an issue, e.g. Calvinist religion and the rise of capitalism), 4) usage and custom (regular patterns of behaviour or long-standing practice) and 5) knowledge (consensual, widely accepted and shared). So, if regimes intervene between these variables (or any combination of them) and outcomes/behaviour, they must not be based solely on short-term interests and must incorporate some sense of a general obligation.

M. Zurn offers another causal variable to this list - a regime-conducive foreign policy.<sup>147</sup> This variable is particularly instructive for the purpose of the analysis: therefore it will be examined more closely. (Although this discussion may belong to the section concerning the conditions for regime creation, this variable will also significantly affect the characteristics of a regime.) Zurn distinguishes between "positional properties" (an actor's characteristics relative to other actors), and "non-positional" properties of an actor. The latter refers to characteristics of the state concerning its society, economy, decision-making processes and its decision-makers, which may influence foreign policy. A particular mixture of these characteristics, in combination with a particular foreign-policy conduct (behaviour), will significantly affect regime creation. It is also true for preventing regimes being created.

A country will be active in creating a regime, if a) it has a competitive economy, with a high dependence on foreign trade; b) it is strongly entangled in international institutions; c) if the state is moderately strong, with a strong social democratic electorate; d) a change in the domestic power constellation occurs, concerning both the governing coalition and public opinion, and e) when the degree



of institutionalization (commitments, resources) of the existing policy is not very high. These characteristics would have to be accompanied by the "faithful voice" policy type: the state should be inclined to use international institutions actively, with an orientation towards reciprocity and one-sided concessions.

Regimes are, also, dynamic institutions, meaning that they are sensitive to changes from within and from the outside world. Changes may be of a different weight, in respect to which regime part is undergoing changes. Krasner argues that changes in the rules and decision-making procedures are the changes within the regime, compared to the changes of the principles and norms that present changes of the regime itself.

Besides being dynamic creations, regimes can have a relative autonomy and a life of their own. Basic explanations for this regime feature are related to different degrees of sensitivity to changes for causal variables and for a regime itself. Namely, once a regime has been created, adjustment to changes in causal variables is usually made through changes in rules and decision-making procedures. Basic causal variables, that led to a regime's creation, are constantly changing; contrary to that, regime principles and norms are more durable. This relative autonomy of regimes is related to the existence of lags (regime components exercise their own impact on outcomes) and feedback (regime can even alter basic in-input variables - calculations of costs and gains, interests, etc.). As Keohane and Nye have put it, what is important is not the initial distribution of capabilities and interests, but organizationally dependent capabilities (developed through the process of bargaining within a regime).<sup>148</sup>

Another important characteristic of regimes is related to their stability, usually analyzed through the degree of compliance with their rules. However, as regimes are intersubjective phenomena, more importance has to be attached to the ontological side of the problem. The characteristic of being more or less stable should be evaluated (measured) from the aspect of a regime's ability to create conditions for the continuation of expectation convergence.

"The key theoretical issue for regime stability is not whether the form of co-operation - the particular mix of procedures and rules - continues, but whether the fact of norm-governed co-operation continues."<sup>149</sup>

The continuation of expectation convergence, or regime stability, critically depends on the degree of institutionalization. This is the process by which norms and rules are evaluated and their legitimacy acquired. R. Smith<sup>150</sup> offers four measures of institutionalization: adaptability, complexity, autonomy and unity. So, a regime will be more stable - its underlying norms will be widely accepted and complied with - if 1) it is more adaptable to passage of time, new functions and new challenges; 2) it has hierarchically and functionally related subunits to deal with particular issue-aspects or concrete stakes; 3) it can exercise control over the entry of new political actors and over the behaviour of the politically most active members, and 4) its

ultimate purposes do not reflect preferences of just one actor or a group of actors, but resemble the fundamental unity of members concerning the regime's ends and means.

Another significant regime characteristic relates to the voluntary nature of this type of international organization. The compliance with rules does not stem from a hierarchical process that sets norms and rules, neither it is backed up by the threat or the use of force. The compliance with a regime originates from the legitimacy the norms and rules acquire, as described above. The rules become binding in the sense that they provide the convergence of expectations and the governance of behaviour. In the words of Parsons and Shils, a regime exists

"... when each actor in the situation does, and believes he should do, what the other actors whom he confronts believe he should do."<sup>151</sup>

So, regimes are intersubjective creations and their characteristic depend primarily upon basic causal factors, i.e. upon a particular mix of them. A regime that is essentially the exercise of a dominant state's power, pursuing its own self-interest, will certainly feature characteristics different from those of a regime created on the basis of widely accepted knowledge, or long-standing usage and custom. Nevertheless, regimes are far from being static arrangements: a prerequisite for their survival is constant adaptability. In addition, they are characterized by a significant (but not an absolute) degree of voluntariness that makes regime norms and rules legitimate.

### **5.3.7. Types of regimes**

Different theorists stipulate different conditions and criteria for identifying types of regimes. According to functions, regimes can be specific or diffuse. In respect of monitoring surveillance, they can be formal or informal. Regimes can go through an evolutionary or revolutionary change, depending on changes in basic causal variables. Concerning the nature of their basic principles and norms, regimes can be more or less biased about the distributional effects.

In order to illustrate these different types of regimes, Puchala and Hopkins give the comparison of the colonial regime (as being diffuse, informal, value-biased regime that underwent revolutionary changes) and the present food regime (as being more specific in function, rather formal, more generally rewarding and undergoing evolutionary changes).

O. Young argues that regimes may differ according to the role of conscious coordination among actors. From that point of view, regimes can be spontaneous, negotiated or imposed. Spontaneous regimes evolve through coordinated behaviour among actors but without any "social engineering" or design and they even do not

require (a priori) explicit consent from the actors. Negotiated regimes are, on the other hand, based on a consciously coordinated behaviour and actors' efforts to reach an agreement on crucial matters. Therefore, they are characterized by formal structures and actors' explicit consent. Negotiated orders may occur in several types - constitutional (Antarctica regime), legislative bargains (UN plans for Palestine), comprehensive (the UN Law of the Sea Convention) or partial orders (some aspects or parts of an issue to be regulated according to practice and precedent). Finally, imposed regimes are created by dominant powers who possess adequate capabilities to compel subordinated actors to conform. Imposed regimes can also occur in different types, as "overt hegemony" (the dominant power creates institutional arrangements in an explicit way and forces subordinates to conform to them), or in a type of "de facto imposition" (the dominant actor promotes favourable arrangements using manipulation of incentives).<sup>152</sup>

As examples, it is possible to compare a) 1973-75 policy coordination among major central banks, in the absence of any "governing" regime (a spontaneous regime); b) 1976 formal agreements to amend IMF Articles of Agreement (a negotiated regime), and c) IMF structural adjustment in the 1980s (an imposed order).

Keohane suggests that regimes can be broadly divided into two types, according to the nature of functions they perform: control oriented regimes (GATT) are created for the purpose of maintaining some degree of control over each other's behaviour; an insurance-type regime (International Energy Agency, STABEX, etc.) is formed in order to share risks and to cope jointly with uncertainty, as well as sharing of related costs.

Regimes may also vary according to the type of political actors that form a regime, so there are international regimes and transnational regimes. International regimes are usually considered as being created by or among state actors, including states and international governmental organizations. However, there are a few examples of corporate actors (the sovereignty-free actors in Rosenau's words) entering the process of self-organization and successfully carrying it out. The Seven Sisters regime for oil in the 1970s, and the Lloyd's regime on war risk insurance for shipping in the 1930s<sup>153</sup> fall into this category.

"All kinds of organizations with the purpose of defending or promoting functionally-defined interests in the international realm are in principle able to implement relatively stable forms of co-operation in the pursuit of their interests. If international non-governmental organizations interacting in an issue-area agree upon principles, norms, rules and decision-making procedures in order to regulate their interactions, one can speak of transnational regimes."<sup>154</sup>

Surprisingly little attention has been paid to these non-state actors in International Relations, particularly bearing in mind a growing interdependence and

a high politicisation of economic issues. A prominent exception in this respect is S. Strange, who consistently puts forth the importance of the business sector for the development and conduct of modern economies. She argues that the world reality is based on four structures: the security structure, the production structure, the financial structure and the knowledge structure. Even though S. Strange takes the conventional structuralist approach to regimes, she explains the financial structure as

"... the sum of all the arrangements governing the availability of credit plus all the factors determining the terms on which currencies are exchanged for one another."<sup>155</sup>

It is clear that "the markets" (or other-than-state actors) are not just the background for state action, but they actively take part in "the sum of arrangements", and sometimes even significantly effect state policy (on both a national and international level).

Although they might seem quite different and separable, international regimes and transnational regimes tend to overlap. If one assumes that the former belong to the state-centric world and the latter to the multi-centric world, the links between the two types of international organization may well indicate the future course of international relations development. As Rosenau puts it

"... this nexus of the two worlds is a prime arena wherein clashes occur between the past and the present, between the tendencies toward decentralization and those toward centralization, between the diminished relevance of force and the growing stress on increased shares of the global market."<sup>156</sup>

To sum up, the most important regime feature, accounting for the differentiation among various types, is the level of institutionalization, explicitness and formalism. So, on one hand, regimes can be highly institutionalized, with explicit rules and widespread membership (Bretton Woods monetary regime). On the other hand, regimes may evolve as less institutionalized and less explicit orders that require no formal arrangements, written agreements or such like (the Seven Sisters oil arrangements).

### **5.3.8. An example: balance-of-payments financing**

In order to summarize the main elements of regime theories, it is useful to conclude with a particular example, namely with the regime governing access to balance-of-payments financing.

According to Keohane and Nye<sup>157</sup>, the post-war international monetary regime was based on fixed exchange rates, the dollar and gold as the reserve assets

and on a moderate level of control over international capital movements. Among related issues, it was established that the international financial institutions (the IMF and the World Bank) would create an adequate volume of international liquidity to support balance-of-payments financing and economic adjustment or investment for development, respectively. Or, to put it another way,

"...the scope of the international monetary system concerns the terms on which national currencies are traded for each other (which influences the size of imbalances), the assets used to finance those imbalances and the arrangements governing when and how imbalances should be adjusted."<sup>158</sup>

Referring to Krasner's definition, four defining elements can be outlined in this example. The basic regime principle would be that the nations should be assured of an adequate, non-automatic, supplementary financing for balance-of-payments deficits. Regime norms were formally articulated by the Articles of Agreement establishing the IMF and they covered both the rights and the obligations of the member states: they have the right to obtain additional resources within quota limits, but they also have the obligation to carry out national policies consistent with the IMF's orientation. Regime rules were derived from the IMF's prerogative of conditionality, especially concerning the upper credit tranches. Decision-making procedures included negotiating with visiting missions of IMF staff and review by the Executive Board, with provisions for voting in the Board, to determine amounts of resources available.

Concerning the regime's creation, it was possible to identify some of basic causal variables that account for regime formation. The self-interest of actors was obviously present, for they all wanted to be assured of an adequate source of liquidity. Knowledge related to previous financial crashes was also present and shared: the "gold shortage" of the 1920s and the financial chaos of the 1930s were too well remembered. Among norms and principles that led to the regime creation the most important were need to avoid international economic rivalry, the desire to maintain full employment and, to a lesser extent, maintenance of the principle of sovereignty of states. Political power, as the causal variable, had a particular impact in the process of negotiating the regime's frame and structure: specific rules and institutional arrangements were developed according to the preferences of the United States (e.g. countries would not have an automatic access to financing, votes were directly related to quotas, etc.). The variable "regime conducive foreign policy" could be also identified. The US was "eager" to establish the regime, for its economy was unquestionably the most competitive one, it heavily depended on international transactions, it was very active in the international organizations and public opinion (as well as the government) was certainly in favour of the creation of the regime. The only suggested variable that it is not possible to identify is "usage and custom", because the regime included an entirely new international economic organization.

The maintenance of the regime could be attributed to more or less stable demand/supply relations (in this particular area) during the 1950s and 1960s. Within this period, the need for balance-of-payments financing was generally within limits of the resources available, and there were no alternative ("competitive") sources of supplementary finance. The development of central bank swap lines and bank credits and the formation of the European Payments Union and the G-10 can be considered as modifications of the regime.

With respect to the regime's purposes and functions, it is obvious that the regime governing access to balance-of-payments financing was created to provide cooperative behaviour, or to put it more precisely, to provide collaboration in order to achieve common goals (the stability of international monetary relations), but also for the purpose of regulating national actions (for economic policies to be in the line with the IMF's objectives).

Regarding the conditions for regime formation, post-war international monetary problems could be analyzed as a collective situation. Bearing in mind the analytical dimensions of a collective situation (Ruggie, 1975), the conditions for this particular regime's creation could be described as being highly politicized; a type of policy interdependence was a combination of contingencies and deprivation (individual state's policies could raise uncertainties for the others or even deprive them of adequate liquidity resources); the locus of policy interdependence was very close to domestic monetary policies, as there was a great need for additional finance; finally, distribution of interdependencies emphasized existing asymmetries concerning the issue-specific power. As it has been suggested by J. Ruggie, the type and locus of policy interdependence taken together give a measure of the intensity of a collective situation. In this particular example, as it included close links with domestic policies and even deprivation, the post-war international monetary "environment" can be described as having been a collective situation of a high intensity. So, the Bretton Woods monetary regime was created as a collective response to that situation.

In addition, several other conditions existed that increased the demand for the regime's creation: there was no higher authoritative institution in that area; there was a growing uncertainty about international monetary "management" and a lack of a clear legal framework for actions.

Finally, conditions for the regime's creation can be analyzed also from the hegemonic stability "point of view": the conclusion of the Second World War resulted in an explicit acceptance, on behalf of the US, of a burden to provide a collective good (monetary stability).

Concerning the mentioned regime characteristics, this regime has certainly proved to be more than an ad-hoc arrangement and not to be based solely on short-term interest. Long-term international monetary stability and predictability of monetary developments have been desired both by the creditors and by the

borrowers. It has also embodied a sense of general obligation, for the member countries had to conduct adequate policies. Finally, it has proved to be a dynamic institution, particularly since 1973.

The last characteristic deserves special attention, because changes that have occurred in the regime induced different, opposed explanations, concerning the current situation in the international monetary system.

As the oil prices began to rise in late 1973, serious disturbances developed, both on the demand side (an increased need for additional financing of oil-importing countries) and on the supply side (limited IMF resources, the abundance of petrodollars, the explosion of private financial markets, etc.).

✓ "The private banking system took over the functions proper to an official institution possessed of the power to finance balance-of-payments disequilibria through credit-granting and to create international liquidity."<sup>159</sup>

Later on in the 1980s problems started to emerge when debtor countries faced serious difficulties in servicing external debt. So, private banks had to turn again to the IMF, to obtain the right to demand changes in the economic policy of "sovereign states": credit would be granted only after an adequate stabilization or adjustment programme for the country was accepted by the IMF.

Regime theorists suggest that changes of the rules and decision-making procedures are changes within the (same) regime, contrary to the changes in the principles and norms that lead to change of the regime itself. Changes in the rules and decision-making procedures in this particular case have certainly occurred: bargaining had to include private banks as well; a new policy of conditionality was introduced in 1979; there have been increases in quotas and the repayment periods have been extended; several new facilities have been created (e.g. the Oil Facility, the Extended Fund Facility, the Supplementary Fund Facility, etc.). Those changes are perceived as not changing the regime, as they are not related to basic principles and norms.

Nevertheless, even if it is accepted that the basic principles are still the same (welfare benefits of the "managed" international economic relations), it is still doubtful if the basic norm remained unchanged. Namely, if it consists of the rights and obligations of the member countries related to the access to balance-of-payments financing, the regime itself could not provide the basis (i.e. required resources) for the right to be consummated. The regime (the IMF) could, at best, give an approval for the right to be exercised.

To sum up, the regime governing access to balance-of-payments financing has existed, it has been of a specific type, very formal and highly institutionalized; it could be located somewhere between negotiated and "overt hegemony" orders because of the heavy specific weight of the US involvement in its creation. It has undergone changes, but one may dispute whether have they been of an evolutionary

or a revolutionary nature, i.e. whether the basic underlying principles and norms are still the same or a new regime has evolved.

As this survey of regime theories has revealed, it is still not possible to draw any general conclusions about their validity and theoretical consistence. Neither it is possible to outline a general regime theory, for theoretical assumptions and conclusions both still vary to a significant extent. However, regime theories have certainly proved their usefulness in analyzing this complex and changing world of today. The insights offered concerning (inter alia) the co-existence of various actors, goals and policies, definitely put more light on international relations. Moreover, as new types of actors and new types of problems increasingly draw theoretical attention, regime theories may evolve as a framework for better understanding of world politics.

In the beginning of the 1990s, regime theories still seemed vague and under-elaborated. Yet, their perspective is wide open because the gap between the extremes of the Realist view and of the idealist one is broader than ever. If the hierarchical power-based order is in a state of decomposition, and if there is still a long way to a world society, a theoretical challenge exists to explain why and how "the games" are played today.

This lengthy theoretical introduction to the field of International Relations aimed at clarifying two aspects of the analysis. Firstly, in order to achieve analytical consistency and draw sustainable conclusions, a definable set of theoretical postulates has to be adopted. The assumptions brought forward by the Globalist perspective seem most adequate among the four paradigms of international relations. The whole first part of the analysis (Chapters 1 to 4) is actually the justification for taking this particular perspective. The first part portrayed the complex nature of the global securities market, in respect of its manifestations and functions, different types of participants and attitudes, etc. The global securities market has emerged as a new phenomenon in the world political economy. Therefore, it is not surprising that the "classical" perspectives on international relations (primarily Realism and Structuralism) could not properly "embrace" it. The rigidity of their basic assumptions proved to be a theoretical obstacle that could not be surmounted, even with later modifications of the original models. It is exactly the "eclectic" nature of the Globalist perspective which makes it theoretically useful for analyzing issues such as the global securities market.

Secondly, the concept of issues offers very important insights for establishing a proper methodological approach to current world phenomena. As the few examples from the fourth chapter have underscored, relations in the modern world are not quite straightforward - not even in the domain of basic economic processes and determinants. Concrete political decisions, on all levels of political reality, are just the outcome of ongoing processes of communication, negotiation and bargaining. They are derived from and they impinge upon various aspects of social



life. How and when the political agenda is going to be formulated, which issues and stakes are going to be perceived salient, why other-than-state actors are becoming important, and other questions like these cannot be neglected any more. Particularly this is the case if the theory has to explain governance networks that emerge in response to complex interdependence. So, the Globalist theoretical postulates and the issue-concept will be combined in the regime theory tradition. This will be done so, in order to examine the existence of structures, principles and norms, that is a regime, in the field of global capital flows.

So far, it has been described from which perspective the analysis will start, how the analysis will examine the phenomenon, and which theoretical hypotheses are going to be tested. In this way, a sustainable analytical framework is outlined. The rest of the analysis will focus on the content of this structure.

## CHAPTER SIX: POLICY COMMUNITY FORMATION

One of the distinctive characteristics of modern economic phenomena is that they can be neither properly examined nor understood using analytical postulates and instruments strictly "confined" to economic theory. The current stage in the world economic development, as it has been outlined in the introduction to both second and third chapter of this study, necessarily requires a complex analytical approach to be taken. This implies, besides picturing the quantitative and qualitative "surface" of a phenomenon, bringing into the analysis some other aspects of the very same phenomenon - political, sociological, psychological, legal and other aspects. So far, the analysis has portrayed the global securities market as to its main roots and components, including the coverage of the major types of actors participating in the market. In addition, the previous two chapters have presented some of the theoretical and empirical justifications for taking this "extended" approach to the global securities market.

Following the choice of Global Politics as the paradigm within which this phenomenon will be analyzed, the attention will now focus on concrete political actors. This part of the study does not aim at listing and analyzing all actors that have emerged on the scene. The effort will be made to point to several central actors whose activities predominantly shape the debate about the global securities market.

As it has already been underscored, what distinguishes world phenomena of today is the multiplicity and great diversity of actors in political processes. Contrary to the previously held theoretical views, states (governments) are not the only actors in international politics. Furthermore, they are not fundamental in their influence to the extent they had been before. The world political scene of today features many changes in types of actors, their relations and structures, issues that are raised, etc. J. Rosenau has labelled this "post-international politics".

"It is a shorthand for the changes wrought by global turbulence; for an ever more dynamic interdependence in which labour is increasingly specialized and the number of collective actors thereby proliferates; for the centralizing and decentralizing tendencies that are altering the identity and number of actors on the world stage; for the shifting orientations that are transforming authority relations among the actors;..."<sup>160</sup>

In the case of the global securities market, many types of political actors take an active part in the process - national associations of bankers and securities dealers, international associations of stock exchanges, international governmental

organizations, and international non-governmental organizations. For each of these actor categories a few concrete examples will be presented, in order to illustrate typical structures, attitudes and activities. Although a general framework for analyzing these different actors was presented in the previous chapter (see the subsections on the Globalist perspective and on the concept of issues, particularly pages 48-49 and 53), further theoretical refinements need to be made before particular types of actors are exemplified.

### **6.1. Political actors in theory**

One of the crucial components of the Issue-Based paradigm is that, contrary to Realism, groups are seen as basic political actors. Mansbach and Vasquez define a political actor as

"any individual or group that seeks to enhance its value satisfaction through making, or contending over, proposals for the authoritative allocation of values."<sup>161</sup>

So, a group of individuals joins together on the basis of the feeling of value deprivation, and they organize their activities in order to use the political system to alleviate this deprivation. Nevertheless, the formation of a political actor is neither a simple nor a straightforward process. Before the actual actor formation, potential members must decide to communicate with other individuals or groups perceived as being in the same situation, or experiencing the same deprivation. Furthermore, even if they decide to enter the communication, they have to be able to do so - a set of conditions must be created to provide effective communication.

As it has already been described, the most important factor in the first phase (i.e. for the decision to communicate) is the status of an actor. It is itself the outcome of a particular interplay of three variables: 1) the perception of value deprivation; 2) attitudes towards politics (marginal interest in politics / more attention paid to politics / a sense of political efficacy); and 3) the availability of stakes for disposal. So, for example, a higher status actor would actively participate in the political system, it would feature higher skills and level of sophistication, it would be more aware of available stakes, but it would also have higher aspirations and eventually seek a greater value satisfaction.

The next important factor in the formation of a political actor is the organizational context, which can be described as a complex of conditions that determines the levels and modes of communication between potential members, their participation and access to the agenda, as well as joint functioning. Two other factors are also significant for an actor to be created: the level of interdependence and of similarity between potential members. It is not just a feeling of the same

"fate" (or mutual suffering and affective bonds) that brings potential members together. It is also a state of interdependence between them, related to the situation when members need each other's resources to alleviate or prevent their joint value deprivation.

What distinguishes a group of individuals from an organization is the emergence of the intra-group division of labour and roles, the development of rules of procedure and the definitions of rights and obligations.<sup>162</sup> This can also be seen as a distinction between micro-political-actors (such as citizens, public officials, leaders of organizations and private individuals) and macro-actors - collectivities.

"Collectivities are actors in the sense that they have authority structures and other mechanisms for sustaining the coherence and coordination of their members, and for maintaining the boundary distinction between themselves and their environments..."<sup>163</sup>

Among these collectivities, the most important types of political actors are states - governments, subgroups (economic groups, local governments, agencies, etc.) and transnational organizations (transnational economic entities, international governmental and non-governmental organizations).

Different typologies of political actors have been developed, emphasizing various sets of criteria. Some of them have already been mentioned in the previous chapter, but more elaboration is needed here. Among major actors in the global systems, Willetts includes: individual people, technical and professional groups, transnational industrial and financial companies, the government ministries and agencies, and various types of international organizations. The latter encompass: a) IGOs - intergovernmental organizations (with membership limited to governments, but with a varying type and scope of links to the environment); b) INGOs - international non-governmental organizations (with members other than the governmental ones, but with a varying degree of reliance on government funding), and c) Iquanqos - international quasi non-governmental organizations (with mixed membership of both governmental and non-governmental organizations).<sup>164</sup>

Mansbach and Vasquez underscore four basic types of political actors, according to the criterion of the group coalescence / fragmentation. These four basic types are unitary actor, coalition, faction and competing actors.<sup>165</sup> Three essential variables that account for qualitative differences among the four types are members' psychological attitudes, group organization and the nature of intra-group communication. The first variable encompasses members' satisfaction / dissatisfaction with the group norms, group performance and internal interactions. So, a unitary actor would be characterized by a significant level of trust and long-term commitments, deriving from outstanding positive group achievements. On the other hand, a competing actor would feature feelings of hostility and distrust among members.

The second variable for the actor differentiation relates to the group

organization. Some actors are more hierarchically organized (the elitist activity, strict lines of authority and division of roles among members, etc.), while others are perceived as being more egalitarian. In the latter case, the whole membership is more active, affective bonds are easily developed, and organization channels are more open for participation and flow of communication through all levels.

The third variable that account for differences among actors is the nature of their communication. Certain groups display frequent or continuous communication that stimulates the development of understanding, common ideas and positions toward matters at stake. Furthermore, "positive" communication and frequent contacts activates the process of institutionalization of members' behaviour and roles.

J. Rosenau goes further beyond the simple identification of actors on the global scene, which requires the evaluation of an actor's effectiveness (the authority it exercises, and the loyalty it receives) and its ability to initiate and sustain actions with repercussions beyond country boundaries.

"While actors may act to preserve or promote particular values, we must often look beyond actors and their capabilities and values to the consequences of their actions for consensus formation, systemic structure, and a host of other analytic implications that are far removed from those who undertook the actions."<sup>166</sup>

So, after identifying important actors on the scene, one must focus on a number of analytical aspects of the actors, such as their orientations, structures, hierarchies and processes.

One of the most important characteristics that differentiates political actors is their ability to adapt to a constantly changing environment, but at the same time preserving the internal integrity. Rosenau highlights four basic modes of adaptation: 1) acquiescent adaptation (a "status quo" adaptation); 2) intrasingent adaptation (an actor tries to shape the environment to itself); 3) promotive adaptation (an actor tries to create a new equilibrium between itself and the environment), and 4) preservative adaptation (to preserve the existing equilibrium between itself and the environment). These four modes of adaptation have been identified, inter alia, as to an actor's attitudes toward new policies, toward other actors and toward changes, toward norms and institutions of the state-centric world, toward making formal agreements and coalitions with other actors, etc.<sup>167</sup>

Typical actors featuring promotive adaptation are governments of "superpowers", ideological political parties, transnational corporations and professional societies. Their scope of external concerns is global and they frequently adopt new policies toward other actors. They rarely enter into formal agreements with other actors, but very often make coalitions. Usually, they have developed a sense of political efficacy, i.e. they are inclined toward manipulating the political system. The promotive orientation also includes extensive efforts to develop new

markets and new allies.

The preservative mode of adaptation is often an attribute of bureaucratic agencies, international organizations, subnational governments, pragmatic political parties and most governments. The scope of their concern with external events varies from case to case, as well as their attitude toward making coalitions. They do not change their policies very often, but try to accommodate to "superior" actors. As Rosenau sees it, the norms and institutions of the state-centric world (i.e. the intergovernmental world) predominate. These actors develop favourable attitudes toward formal agreements with other actors, but the quest for reciprocity underlies the development of new markets and allies.

The acquiescent mode of adaptation is characteristic for weak "satellite" governments and refugee groups. The fourth mode, intrasingent, is most often a feature of ethnic groups, labour unions and pariah governments. As the involvement and the importance of these two groups of actors in global financial issues are rather limited, their characteristics will not be examined here.

The purpose of this introduction was to emphasize a number of characteristics which has to be included in the analysis that follows. The analysis of each actor must be examined from different aspects. The first, most obvious criterion is undoubtedly its membership composition. Then, the historical context of the actor's foundation must be explored, in order to focus on its basic goals and functions. The organizational aspect is the next criterion by which an actor has to be examined, including the analysis of its hierarchies and degree of centralization, the division of roles, decision-making procedures and the existence of disciplinary mechanisms. This could display a picture of the internal processes carried out within an actor. In addition, an actor's past performance (activities, successes, failures) and interactions have to be taken into consideration. The latter primarily covers actor's attitudes toward developing formal agreements and/or coalitions, as well as attitudes toward participation in the political system. As much as will be possible, each of the actors will be analyzed bearing in mind these distinguishing characteristics.

## **6.2. Political actors in reality**

A survey which follows aims at highlighting a great diversity of actors that have entered a world-wide debate about the global securities market. If the Issue-Paradigm methodology is applied, the rise of the global securities market can be perceived as a component of the global economy hyper-issue.<sup>2</sup> The involvement of

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<sup>2</sup> The concept of issues was introduced in Chapter Five, subsection 5.2.5.

each and every political actor in this global debate reflects its own feelings of issue-salience. Sometimes, an actor perceives that a concrete, technical stake is of the greatest importance to it. Other actors can discern more abstract stakes, or values, as being under the contention. Some actors may be inclined to contend over and concentrate on particular stakes, while others may take a wider approach and "extend" the debate over more general principles. In order to make this part of the analysis more understandable, the survey will start with the actors most directly "connected" to securities market (e.g. national associations of banks and securities dealers), on the assumption that they will experience the deepest feeling of value deprivation. The survey will conclude with the analysis of international fora such as the United Nations, of course in relation to the issue.

### **6.2.1. Banks and dealers**

This group of political actors features the greatest diversity, as to each actor's origins, aims, structures and basic underlying values it seeks to promote. Various banking and other associations take very different attitudes to politics and the actors in the intergovernmental world, as well as to other actors. Their involvement in debates over technical and organizational stakes in relation to securities market also varies to a great degree.

#### **6.2.1.1. National Association of Securities Dealers (USA)**

The National Association of Securities Dealers (NASD) is the self-regulatory organization of the securities industry in the United States, formed in 1938. It was established by co-operative efforts of Congress and the Securities and Exchange Commission, in order to

"... promote the investment banking and securities business, to standardize its principles and practices, and to promote high standards of commercial honour and observance by its members of federal and states securities laws."<sup>168</sup>

NASD is certainly among the most important actors in securities markets world-wide, as it comprises about 5 400 securities firms and about 10 million investors. Its basic function of facilitating capital-raising serves investors, public companies and broker-dealers from the US. Apart from that, there are members from 48 other countries, operating in the US. In these terms NASD is the biggest secondary market in world-the world. In addition, NASD is certainly among the most active actors taking part in the global debate on securities markets. It has joined almost all relevant international organizations, as well as other associations in the sphere of

banking and securities business. Although more concerned with technical issues to promote efficiency of markets, NASD vigorously participates in many international fora to ensure that the views of its members are efficiently communicated and protected.

The organization of NASD is very complex, and has been developed along three lines: specific business areas, regional areas and particular issues and problems. The Board of Governors is at the top of the pyramid, and it determines policy both on a national scale and for international activities. Various standing committees (currently, 25 of them) work directly with the Board, each covering a specific area, such as arbitration, congressional/state liaisons, international business, national business conduct, etc.

Another dimension of NASD's organization is the set of fourteen district committees, as agents of the Board in executing NASD policy. There are also special committees or task forces that are appointed to study current problems as the need arises.

The NASD organization is a broad-based one, but rather hierarchical in its nature. However, frequent communication is encouraged, particularly by the work of the NASD staff. A highly developed sense of political efficacy is embodied in the Law and Regulatory Policy Division. There is, *inter alia*, a special office established to keep close contacts with regulators - the Office of Congressional and State Liaisons. Its main tasks include maintaining contacts with legislators and other officials at both the federal and state levels, monitoring legislative developments, and communicating views of its members and the investing public to regulators.

In order to foster positive communication, special attention is paid to internal flows of information. Under the Marketing and Market Operations Division, there are two particularly important sub-divisions: Corporate Communications (to maintain liaisons with the media and the academic community) and Investment Banking and Institutional Relations (to maintain close liaisons with the corporate finance and syndicate departments of members, as well as with institutional investors).

Basic purposes of NASD, as described in its By-Laws, are to develop, operate and regulate (as far as permitted by the top US regulator - the Securities and Exchange Commission) securities markets that are, first of all, efficient, fair and liquid. In addition to that, the NASD endeavours to promote high standards of behaviour, self-discipline of members, compliance with law, protection of investors, etc. This ordering of the basic aims has to be underscored, as it clearly presents ranking of the values that underlie the actions. The value of wealth is perceived as the most important one to be protected and promoted. Among the actors examined from this group, NASD most explicitly commits itself to the promotion of efficiency, before other objectives.

However, it is recognized that the efficiency cannot be promoted without a close cooperation with other actors, such as stock exchanges, clearing corporations,



etc. It is particularly the case if fraudulent or other criminal practices, a low level of professionalism, and weaker market-oversight develop to threaten market efficiency. For that reason, NASD has developed extensive external relationships. In the US, it maintains close liaisons with the SEC, various Congressional committees, State governments and other government agencies. Recently, it has proposed amendments to some SEC rules, in order to increase market liquidity, and to enhance market surveillance and transparency. So, contrary to widely-held beliefs, the objective of efficiency and the one of order (safety) are not in conflict. As seen from the NASD aspect, they are complementary. The most sensitive political question, in relation to this, is how to balance the "weight" of each of the objectives in the regulatory process.

Apart from that, NASD has joined different "national" and international associations, as well as certain governmental (as an associate member) and non-governmental organizations. NASD is a member of the International Securities Market Association, the British Merchant Banking Association, the International Federation of Stock Exchanges, etc. This highly active attitude of NASD assures its members that political boundaries will not limit their endeavours to promote efficient capital-raising.

#### 6.2.1.2. Federation of the German Stock Exchanges

The Federation of the German Stock Exchanges comprises eight most important exchanges in Germany, and although small in relation to some other actors on the scene, the Federation features certain unique characteristics.

Its organization is similar to most of the other federations. The Assembly of Members is at the top of the structure, consisting of Deputy Chairmen of the Board of Governors of each of the stock exchanges. It relies on the work of the Advisory Council, whose membership composition reflects the rather-unequal position of the members. The two most important market places (Frankfurt and Dusseldorf) are represented on the Council by six seats, and all the other Federation members have just three representatives. Although not formally linked, the Federation operates closely with the Federal Association of Official Stockbrokers and the Federal Association of Unofficial Stockbrokers. Far more important, the Federation maintains very close liaisons with the regulators (Federal and Land governments) and the German central bank. Recently, it has even transferred its full membership in the International Organization of Securities Commissions (IOSCO) to the Federal Ministry of Finance. IOSCO is an inter-governmental organization that includes securities regulators from more than 60 countries. This change clearly illustrates attitudes toward finance and banking in Germany: government regulation is the only mechanism that will ensure "proper" services being delivered from the financial markets. It is explicitly stated in the Introduction to the Annual Report of the

Federation that

"... Germany's financial markets do not lead a life of their own. They form a part of the overall system of a social market economy the main element of which is conciliation and not confrontation. It is worth noting that the collaboration between the legislature, the Bundesbank and the financial markets in an atmosphere of mutual trust is more promising approach than if individual participants go it alone."<sup>169</sup>

A surprisingly-high degree of submissiveness to the governmental world is also exemplified by the Federation's attitude toward the regulation of financial markets. Contrary to a growing trend of self-regulation in other countries, the Federation stipulates a gradual shift in the opposite direction: from self-regulation to legal rules.

"In the light of the progressive globalisation of securities trading and the growing number of market participants some rules that were observed in the past even without sanctions *have* to be extended and placed on a legislative basis (*italics added*)."<sup>170</sup>

Analyzing the Federation's approach to international regulation, two particular points have to be made. Although the concentration of supervision is desirable within the country boundaries, when it comes to the international level a sufficient scope of independence from internationally-agreed rules must be preserved. Apart from this, another special interest has to be protected, namely the treatment of universal banks (which are by far the most predominant banking form in Germany) in international regulation.

Another rather unique feature of the Federation is a significant level of tolerance toward internal divisiveness. It allows its members to undertake completely independent actions. For example, the Hamburg SE has supported (and hosted) the creation of the Federation of Scandinavian Stock Exchanges. It has also organized the 30th World Congress of the International Chamber of Commerce. The Federation allows its members to pursue their actions in accordance with different objectives and accents. For example, the Berlin SE is predominantly engaged in the privatization of the eastern part of Germany and in assisting financial institutions in Eastern Europe, so it puts forward the objectives of independence and freedom to operate. The Frankfurt SE, on the other hand, is mostly oriented to other major SEs abroad (specially in the US) and it stresses the objective of market efficiency and equality on a global basis.

However, due to frequent communication, there is a high level of consensus within the Federation on the most important issues in relation to banking and securities trading. These issues include the regulation of secondary markets, clearing and settlement, and the emerging capital markets in Eastern Europe. This consensus is built on a widely-accepted axiom that a prerequisite for a "good" functioning of the capital market is confidence, deriving from government regulation and supervision. So, the values of safety and order are placed far above all the others.

In addition, the efficiency aim is underscored by insisting on the premise that the functioning of capital markets has always to be examined in a broader socio-economic context, e.g. in relation to monetary policy and foreign policy. The very same premise again emphasizes the Federation's posture toward the norms and institutions of the intergovernmental world. It prefers the accommodation posture, rather than to use opportunities to manipulate the political system.

Even though the Federation is a member of several international organizations that deal with securities market, it is still fairly hesitant toward formal agreements or coalition building with other actors. By insisting on independence (e.g. from international regulatory rules), it actually seeks to adjust itself to the existing environment.

#### 6.2.1.3. Japan Securities Dealers Association

The Japan Securities Dealers Association (JSDA) exemplifies another type of actor that can be identified on the global scene. It was founded in 1973, but it originates from the prefectural securities dealers associations established in 1940 and 1941. As the JSDA was established under the post-war laws, made to resemble the US approach toward the securities industry, it is formally recognized as a self-regulating organization (similar to the position held by the NASD in the US). However, as the analysis will reveal, the Japan Association and the NASD are comparable to a minimum extent.

Today, the JSDA membership comprises 267 securities firms, 50 of which are foreign firms. Under the current regulations (the Securities and Exchange Law and the Law on Foreign Securities Firms), all domestic securities firms and foreign firms with branch licences have to join the Association. It is not very often that a single professional association has such a country-wide membership to encompass all firms in a particular sphere of activity. Although it is not explicitly stated<sup>171</sup>, the authorization process (granting the licence) is definitely linked to application for membership in the JSDA.

The basic aims of the Association are

"to contribute to the protection of investors and to ensure that both domestic and foreign securities transactions, conducted by member firms, are fair and smooth. It also aims to promote the sound development of the securities industry."<sup>172</sup>

In order to achieve these ends, the JSDA has defined its goals as being primarily related to the promotion of compliance by member firms with the law, and to the maintenance of order among firms. In addition, but rather secondary to those ones, the JSDA will work to enhance the public faith in the market and to promote efficiency of the market management. Much of its activities are devoted to the supervision of the market, enforcement of its rules and communication with the

government and other relevant organizations.

A unique feature of the JSDA, however, relates to the absence of any explicitly-stated goal for promoting efficiency of the market transactions. So, even though it has been established to resemble the role of NASD in the US, today the Association mainly acts as an lengthened government-hand, over the market. This is particularly well exemplified by its complex organization. Central bodies of the JSDA are the General Assembly, Board of Directors and the Central Council. The large Board consists of 39 directors and five auditors that "monitor" its work. The Council is even a larger body (having in mind the overall size of the Association), with 53 representatives from member firms, affiliated organizations and academic authorities. In addition, there are numerous standing and special committees, each with subcommittees and expert advisory committees. Finally, there is a Disciplinary Committee to provide advice and recommendations regarding the discipline of member firms, their executives and employees.

This highly centralized and hierarchical structure fosters communication, but primarily from the top down. Analyzing the survey of its main recent activities, one can conclude that the JSDA is far more sensitive to external demands specially if they come from the part of the government and its agencies. It is also clear that the basic values which should be protected are order and safety, far ahead of the efficiency (wealth) or freedom.

Recently, however, there has been a noticeable change in the orientation of the Association regarding its basic goals. In March 1992, it hosted the annual meeting of the International Councils of Securities Associations (ICSA) in Osaka. It was agreed that all the members should endeavour to facilitate international transactions in the market and work toward promoting efficiency of the market. The JSDA fully accepted these objectives and emphasized the need for enhancing mutual understanding and sharing of information among members.

#### 6.2.1.4. Luxembourg Bankers' Association

The Luxembourg Bankers' Association (ABBL) is not a particularly high-status actor on the scene, but it is worth mentioning because it represents a full contrast to the actors from Germany and Japan. The Association's significance for the analysis stems from two sources. One is the place occupied by the Luxembourg centre on the Euro-market, and the other is a wide scope of concerns and activities of the Association.

The Association was created in 1939 by ten leading private banks of Luxembourg, and since then it has grown to an entity counting 142 members. The diversity of its membership is rather unique, as less than 10 percent of the members are originally from Luxembourg. In addition, the Association comprises different types of banks and financial institutions, such as commercial banks, securities

houses, saving banks and even an international clearing system Centrale de Livraison de Valeurs Mobilières (CEDEL). Such multinationality and diversity derive from a particular position at the centre in the world of finance. From the beginning of the 1960s, Luxembourg has been progressively liberalizing the financial sphere, and in 1965 the withholding tax was abolished for group financial holding companies. As far as capital markets are concerned, firms from Luxembourg (operating in Luxembourg) today underwrite almost one-fifth of all Eurobond issues. The Luxembourg stock exchange lists almost 70 percent of all Eurobond issues.<sup>173</sup> So, a distinctive feature of the ABBL is that it is not a "national" association in the strict sense, consisting of Luxembourg banks. It is a "national" association from the functional, market aspect, comprising almost all banks that operate therein. This characteristic is common to many associations in leading financial centres, particularly in the UK. But, it is by far most emphasized in Luxembourg.

The ABBL has always carried out highly-varied and far-ranging activities, from organizing special courses for bank staff, developing contacts with authorities, establishing CEDEL, to promoting the Luxembourg financial centre abroad. In the early 1950s, the Association began to act as a "spokesman" for banks in dealings with the public authorities. A wide range of its concerns includes a broad economic environment (taxation, legislation, regulation), both at the national and international level, banking regulation at home and abroad, collective labour agreements, education, public relations, etc. What is even of a greater importance, the ABBL is the "spokesman" and negotiator for these matters for the sector as a whole. So, despite a great membership diversity, the Association has developed intensive and positive communication among its members, as well as a high level of consensus and a joint position toward many common stakes.

"The aims of the Association shall be to protect and develop the professional and employers' interests of its members and to study all matters that might be of concern to the banking profession."<sup>174</sup>

As an actor highly sensitive to internal demands, even more than to external ones, the ABBL has always paid attention to market developments at home and abroad. It was upon the ABBL's initiative that CEDEL was created, in order to promote international clearing and settlement. Since the 1960s, the ABBL has maintained close liaison with other international organizations in the sphere of banking and finance, such as the Banking Federation of the EEC, and banking associations from abroad. As its main aims are to promote the members' interests, the ABBL devotes much of its activities to enhancing market efficiency and technological infrastructure. For the same reason, it has extended its concern over many fields, like employment relations, taxation, international regulation, etc. Regardless of the "national" origins of its members, the ABBL has always strived to protect and promote their interests by equal treatment of them.

The Association is a highly-adaptable actor, as it reacts promptly to any initiative that may affect its members' interests. The ABBL has been particularly active in commenting on, for example, EC proposals and directives related to banking. By the same token, it takes a favourable posture toward formal and informal agreements with other actors, both at home and abroad. The Association has a strongly-developed sense of political efficacy, i.e. a positive attitude toward opportunities to influence and manipulate the political system. The ABBL has worked toward strengthening its liaisons with the Luxembourg Monetary Institute (the supervisory body for the banking sector). A Consultative Committee has been established, including four ex-officio representatives of the ABBL.

The organization of the ABBL is not very complex: there is the General Assembly and the Executive Committee, whose work is supported by a number of highly-specialized technical committees, ad-hoc committees and the Secretariat. However, the structure of the Executive Committee is rather unique. It is composed of ten members, three of which represent three biggest (originally) Luxembourg banks. The other seven members represent major geographical groupings of banks established in Luxembourg: US, French, German, Japanese, Italian, Scandinavian and Swiss. For some unknown reasons, it is decided that various American banks, for example, can more easily reach a common position than commercial banks between themselves, or investments banks between themselves, or alike. However, even though the ABBL emphasizes its multinational structure, when it comes to executive decisions the treatment is slightly less egalitarian - in favour of domestic banks. In addition, both domestic and foreign <sup>banks</sup> accept that each and every action and decision has to be evaluated from the perspective of the Luxembourg centre's competitive position.

So, despite its quasi-national nature in respect of the membership, the ABBL is very "national" in respect of the ultimate decision criterion. Undoubtedly, the concern is not the efficiency of the market per se, but the competitive efficiency of Luxembourg in relation to other centres.

#### 6.2.1.5. British Bankers' Association

One of the most prominent actors in the debate about the global securities market is indisputably the British Bankers' Association (BBA). Since its foundation, the Association has grown to encompass 323 members from 62 countries, representing all major universal, commercial and investment banks. It has to be pointed out that the BBA is one of the very few associations that also have representatives from other banking groups and associations.<sup>175</sup>

The BBA is a very high status actor, influential and successful in representing its members' interests to relevant bodies and the public. It is clearly stated that

"the BBA's principle role is to give expression to the banking industry's views on domestic and international developments... The Association seeks to make these views known to ministers, their officials, Parliament, the Bank of England, the various European Community institutions, other international bodies, the press and media."<sup>176</sup>

So, above all, it seeks to establish effective channels through which the political system can be manipulated and political decisions affected both at home and abroad. Moreover, it aims to build extensive external relations not just with regulators, but also with various professional societies and organizations. In 1991, for example, the BBA took an active part in meetings of the Foreign Exchange Committee in New York, the International Chambers of Commerce in Paris, the International Accounting Standards Committee and the United Nations Commission on International Trade Law.

The scope of the BBA's concern is too wide to be presented here, but certain remarks have to be made. In the sphere of consumer protection, the Code of Banking Practice was published in 1992, jointly with the Building Societies Association and the Association for Payment Clearing Services. Entitled "Good Banking" it establishes for the first time a standard of good practice for the conduct of personal banking. In relation to accounting, the Association has produced a series of standards for the banking industry in the form of statements of recommended accounting practice (SORPs). The success of the BBA in communicating its views to legislators is particularly evident in the case of these recommendations. Namely, in commenting on the EC directive on disclosure of bank accounts, the UK Department of Trade and Industry took the position that the SORPs, rather than legislation, are the right way to address disclosure issues.<sup>177</sup> The Association is specially active in the sphere of crime prevention and money-laundering. Since 1990, it has participated in the Bank of England's Joint Money Laundering Working Group. Results of these efforts were first published in 1990, as the "Money Laundering Guidance Notes" for banks and building societies. In 1991, a similar set of notes were published for investment and insurance business. Apart from this, the Association has set up the Fraud Intelligence Unit, as a major step to combat fraudulent practices in banking.

However, most of the BBA's recent activities are devoted to commenting on and discussing various EC Directives related to consolidated supervision, capital adequacy, large exposure, etc.<sup>178</sup> In reviewing these drafts or directives, the BBA pays attention to details of the proposed measures, as well as to their overall impact on the UK position relative to other centres. It is exactly the comments on these directives that most clearly exemplify the basic aims of the BBA:

"In both cases [a directive on investment services and a directive on capital adequacy] the BBA has sought to defend the principle of free trade ... and to ensure that important points of detail are not sacrificed in an attempt to

find quick and easy political solution.<sup>179</sup>

Having in mind UK financial history and the liberal attitudes towards finance and banking, it is not surprising that the crucial aim of the BBA's activities is the promotion of free-trade principles. Freedom to operate and competition are the basic forces to improve market efficiency, and over-regulation can just endanger the "proper" (free) market functioning.

"At home and abroad the BBA will continue to stand for open markets, for free trade and for regulation which is effective without being bureaucratic or burdensome. It will also be important for the banks established in London to support every initiative to ensure the continued primacy of London as an international financial centre."<sup>180</sup>

A particular example of this approach is the BBA's comment on the EC investment services directive. From the BBA's point of view, it is important that investment banks are treated equally in relation to commercial banks, that host states should not be allowed to restrict dealings to "regulated markets", and that banks are granted direct access to securities markets.

Another major aim of the Association's activities can be described as the maintenance, on a general level, of the relations and structures already established. This posture towards preservation is, of course, derived from the leading position of London as a centre in international finance. Also, it is built on a long-standing practice of self-regulation and confidence in banking in the UK. Commenting, for example, on the Bingham Report and following discussions to strengthen regulation, the BBA stressed that

"... the BCCI episode should be kept in perspective and, in view of the highly distinctive nature of the institution concerned, it would be quite wrong to contemplate major changes in the supervisory framework applying to the banking system as a whole."<sup>181</sup>

The Association usually takes a favourable posture toward making agreements and alliances with other associations and groups. In 1990, for example, the BBA worked particularly closely with the British Merchant Banking and Securities Houses Association and with fellow banking associations abroad to reach a joint position on the EC Directive on Takeovers. In the following year, the BBA formed an alliance with eight other leading representative bodies (the "Group of Nine") in order to present a united front to the Inland Revenue. At stake was a proposal on the taxation of foreign exchange gains and losses.

The BBA's high-status feature is also evident in relation to major regulatory changes abroad. The Association does not only seek to comment and influence regulatory policy at home, but it also endeavours to make its views known to regulators in other countries. This was the case when, in 1991, the US Treasury introduced the legislation which should force foreign banks in the US to adopt a subsidiary structure and to meet US capital standards.



Although the BBA's primary concerns lie in the sphere of efficiency, it does pay due attention to the values of order and safety, both for its members and banking customers. The SORPs, mentioned above, are the proposals to introduce more order and transparency in financial positions. Another example is the Review of Banking Statistics, initiated in 1987, with the twofold aim of providing the government with accurate macro-economic data, and providing supervisors with extensive information in line with international supervisory agreements.

So, the Association most clearly exemplifies a new type of political actor emerging on the global scene. Its scope of concern is rather wide, it is open to various agreements and coalition building with other actors, it has a well-developed sense of political efficacy, and above all, it seeks to make its views clear and properly communicated to fellow associations, domestic and foreign regulators and international organizations.

#### 6.2.1.6. British Merchant Banking and Securities Houses Association

The British Merchant Banking and Securities Houses Association (BMBA) was founded at the beginning of 1988. Three years later, it consisted of 57 members representing major investment banks, securities houses of big commercial banks and some universal banks from all leading financial centres.

A particular feature of the BMBA, due to which it is included in this survey, is its dual approach to the global debate on securities markets. Being represented in the British Bankers' Association, the BMBA sometimes takes this "indirect" route to present its views to legislators and the public. This is usually the case when the issue at stake is of a high salience, and affects the protection of certain basic principles - for example, seeking an equal treatment for banks and securities houses in relation to EC legislation. The high status of the BBA and its well elaborated machinery ensure the BMBA that its views are going to be communicated more effectively, and probably with a greater impact on debates.

However, when it comes to stakes and issues particularly relevant for investment banking, the BMBA prefers to enter directly into debate. For example, in 1989, the Association invited the Chairman of the US Securities and Exchange Commission (SEC) to discuss certain regulatory measures affecting UK offers in the US. Another example is securities trading and policy formulation within the London stock exchange. Although the British Bankers' Association maintains close liaison with the Stock Exchange, the BMBA preferred to exert more direct influence and has joined the Stock Exchange's Equity Market Development Group in 1990.

There is, nevertheless, a third route the BMBA can take in dealing with certain more complex issues, such as the prevention of money-laundering. As it has been mentioned, the Bank of England has established the Joint Money Laundering Working Group, in order to enhance cooperation between banks and regulators on

this particular issue. Although being "indirectly" represented (through the British Bankers' Association), the BMBA has also joined the Group itself in order to enhance investment bankers' cooperation.

Even more than other associations in the sphere of banking and finance, the BMBA is very open to cooperation and consultation with other actors. Its external links include formal and (more often) informal consultations with Ministries and government departments, self-regulating organizations, securities associations, etc. These links are by no means restrained by geographical or political boundaries. The BMBA maintains close relations, for example, with the National Association of Securities Dealers (US), as well as with the International Councils of Securities Associations.

The Association rarely enters into formal agreements with other actors, but maximally uses opportunities for making coalitions. In 1990, it has undertaken the initiative to create a European federation for securities industry, parallel to the already existing Banking Federation of the European Community.<sup>182</sup>

The main objective of the Association, very similar to the one of the NASD in the US, is to represent the members' interests in maintaining pressure necessary for reductions in costs and improvements in the market efficiency. In addition, as its members greatly benefit from London's role in international finance, the BMBA has sought to preserve such role.

"The objective of the BMBA is to provide constructive reaction to regulatory initiatives, both in the UK and internationally. Whilst recognizing that the interests of our Members are best served by operating under effective systems of supervision, it is important that regulation does not impose unnecessary costs or prejudice the attractiveness of London..."<sup>183</sup>

In addition to improvements in market efficiency, the BMBA strongly emphasizes the need to protect the value of freedom, namely freedom of entry and to operate on foreign markets and freedom of choice for investors. This is clearly stressed in the BMBA's comments on the proposed EC Investment Services Directive. Related to this, the Association presses for a flexible approach for information disclosure and publication of trade details on behalf of market-makers. International regulation in this field would have to pay more consideration to each country's tradition and culture, and allow for certain regulatory modifications accordingly. Such posture expresses a long-standing confidence in banking in the UK and an increasing reliance on self-regulation therein.

Contrary to the approach usually taken by the British Bankers' Association, the BMBA does not insist on regulatory details to be agreed and included in every directive or agreement. Basic principles of freedom and equality among and between market participants should be agreed upon, but it should be up to every government to decide on modes of their implementation.

"It seemed unlikely that early agreement could be reached on any over-

detailed text [of the proposed EC Takeover Directive]; the BMBA therefore continued to advocate a Directive that did no more at this stage than state general principles, leaving each country's competent authorities to implement them in the context of their national culture and legal structure."<sup>184</sup>

Even though it is obvious that the BMBA is hesitant to support any form of heavy national or international regulation, it nevertheless recognizes the need to establish a proper set of standards for conduct of financial business. It soundly advocates a high value of practitioner input therein, as well as a closer cooperation in this field both nationally and internationally. The latter basically refers to a much needed collaboration between the International Organization of Securities Commissions (IOSCO) and the Basle Committee on Banking Supervision.<sup>3</sup> This is particularly important as IOSCO and the Basle standards should be complementary parts of the same regime governing global financial transactions. Even greater importance is attached by BMBA to work of different international non-governmental organizations (for example, ICSA) and their regular contacts with national and international regulatory bodies.

The Association's openness and cooperative attitudes, as well as the multiplicity of channels it uses for lobbying, is a good example how new actors are formed (or existing actors adapted) as a result of the changing nature of world politics. Global politics is exactly made up by this kind of actor.

### **6.2.2. International non-governmental organizations**

This group of actors that has emerged on the global scene comprises various "professional" associations and organizations. The attribute "international" is used here in a different context, i.e. to emphasise characteristics different from those usually understood by the term. In common parlance, "international" means something existing or occurring between nations, or a group, enterprise or organization having members or dealings in several countries.<sup>185</sup> However, the term "international" in this analysis refers to organizations and associations which are not primarily oriented to maintaining or promoting the competitive role of the centre they are established in. All "national" associations, presented in the previous subsection, have multinational membership to a higher or lower degree. In the ordinary language, they could all be termed "international" associations. Nevertheless, as it was exemplified by the Luxembourg and British associations, their "national" character derives from the main decision criterion - whether a development / decision is harmful or beneficial to the centre's position on the global

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<sup>3</sup> More details about both actors can be found in the subsection 6.2.4.

scale.

On the other hand, "truly" international organizations and associations are predominantly concerned with more general issues. They are usually related to the whole of the securities market, or to its particular segments, such as bonds or shares, primary or secondary markets, etc. These issues are not dealt with from the aspect of any particular "national" financial centre, but from much wider perspectives. The latter cover, for example, the overall technological infrastructure, standardization of business practices, general codes of conduct, and alike. So, one has to distinguish two aspects of the attribute "international". In the standard use, the attribute relates to an organization that is international in structure. However, it can also relate to an organization that is international in scope, from the aspect of values and stakes pursued. What has to be highlighted here is that the two are not necessarily correlated.

#### 6.2.2.1. International Primary Market Association

The International Primary Market Association (IPMA) is the trade association which represents leading firms in underwriting and management in the international capital markets. It was founded in 1984, and nine years after that IPMA had just fifteen member firms. With an extremely limited entry to it and with an exceptional structure and organization, IPMA certainly deserves to be included in this survey. One can argue that a single case like this is not sufficient for any generalisations to be made, but exactly the opposite is true. Examples like this may well point a direction in which international associations, in the sphere of banking and finance, could develop their organizational structure. IPMA clearly illustrates how the formation of new actor is heavily influenced by market developments, functions and structures.

IPMA represents a very closed and elitist-directed association. According to the Articles of Association, the number of members was limited to one hundred. The membership criteria include two requirements: a) a prospective member has to be a successful bookrunner in Eurosecurities, already established in the market, and b) a prospective member should be a member of the International Securities Market Association - the main self-regulatory organization in the secondary market.<sup>186</sup> The first criteria requires that a member has run the books during the three preceding years (alternatively, two years) in at least an aggregate of nine issues (alternatively, six issues) of Eurosecurities. It is also exactly defined which financial instruments shall be considered as Eurosecurities: they have to be denominated in one six major currencies or in ECU, and they have to be distributed on an international basis (i.e. outside the currency's country of issue). The second condition requires that, besides being active in the primary market, a potential member accepts principles and rules established in the secondary market. It is sought, in this way, to overcome the

functional and other separations of the securities market, and to ensure that the transactions in securities are treated as a whole.

Another unique feature of the Association is its organization. The highest body is the Board of Directors, which decides upon the general policy of the Association and upon all matters relevant to the proper functioning of the market. The Board composition resembles structures of the primary securities market, in terms of major currencies for denomination of securities. Its composition

" ... shall, so far as possible, represent the principal currencies or units in which Euro-Securities are denominated and the number of members of the Board representing each such currency or unit shall reflect the volume of issues of Euro-Securities..."<sup>187</sup>

For example, in 1990, the US dollars were "represented" by nine Board members, and each other currency or unit by one member.

The Association is closed to other associations or organizations, except for the ISMA which is allowed to be represented by one ex-officio Board member. From time to time, additional members could be co-opted, provided that the number of such members should never be more than one-quarter of the whole body.

A rather hierarchical structure of the Association is based on two separate communication flows: decisions and recommendations (from the top down), and members' information (from the bottom to the top). In addition, work of the Executive Committee and of other committees is carried out within strictly defined limits of delegated power, and is always closely monitored by the Board.

Regarding the main objects of the Association, the highest importance is attached to the promotion of cooperation between the primary market participants. In addition, the IPMA seeks to promote the standardisation of market practices and to enhance the technological (information) infrastructure of the market. Some of the recent IPMA activities towards these ends include publication of the "IPMA Recommendation" (a proposal for a code of conduct for the industry), and the introduction of the IPMA Screen Communication System. The latter enables a lead manager to syndicate a deal by computer and simultaneously to invite all prospective members of the syndicate into the deal. So, the efficiency of the market is certainly by far the predominant concern of the IPMA and it clearly stated that the IPMA's objective is (inter alia)

"... to promote and develop the primary market in International Securities so as to bring about the greater efficiency and serve the interests of the market."<sup>188</sup>

It is not very often that, in such an explicit way, interests of members are identified with (or even subordinated to) interests of the market itself. Having in mind that the IPMA epitomizes the "core" of the primary market in Eurosecurities (i.e. the leading managers), it is not surprising that its members perceive their interests as being best served if the interests of the market are protected.

However, the efficiency aim and the value of wealth are not the only concerns of the IPMA. It is also active in providing information to members (e.g. in relation to regulatory changes), as well as in offering knowledge and expertise to the governments and other agencies. In comparison to other associations in the sphere of banking and finance, the IPMA is much less concerned with the enforcement of its rules, or with its members compliance with law. Nevertheless, it makes its views known in relation to major regulatory initiatives, such as the draft EC Investment Services Directive.

#### 6.2.2.2. International Securities Market Association

The International Securities Market Association (ISMA) is one of the very high-status actors participating in debates about the global securities market. Such status derives from several features: the number and multinational range of its members, the success in creating and enforcing market rules, the position held in a few of the most important international fora and the respect its views enjoy therein, and the multiplicity of its communication channels - both internal and external. ISMA is the only international securities self-regulatory organization (ISSRO) in the UK. Under the 1986 Financial Service Act, ISMA has been delegated powers to regulate and supervise the international and Euro-bond market. In 1988, the UK Securities and Investment Board granted ISMA the status of a Designated Investment Exchange (DIE).<sup>189</sup> In 1990, the Association was granted affiliated membership of IOSCO, and in 1991 became a member of the International Councils of Securities Associations (ICSA). In 1990, ISMA applied to the EC Commission for negative clearance of its statutes, ensuring that ISMA is compatible with articles of the Treaty of Rome.

ISMA, originally the Association of International Bond Dealers (AIBD), was founded in 1969 and is based in Zurich. In 1992, it comprised some 900 members, including all of the important banks and investment houses from Europe, North America, the Middle East and Far East and the Pacific Basin. They are all heavily engaged in international securities transactions, i.e. in the secondary market for bonds and equities outside the home country of the issuer. Apart from banks and other financial institutions, EUROCLEAR and CEDEL are also members of the Association.

ISMA's truly global orientation is also exemplified by the scope of instruments<sup>4</sup> transactions<sup>4</sup> in which<sup>5</sup> have should be transacted under its recommendations. They include securities denominated in 22 currencies, international multiple-currency unit bonds, ECU bonds, foreign US-dollars bonds, and Special Drawing Rights bonds.<sup>190</sup> So, in this respect, ISMA is a unique organization concerned with the whole of the global securities market transactions (excluding pure domestic transactions).

The foundation of ISMA coincided with a rapid development of the Eurobond market in the second half of the 1960s. As Euro-market transactions grew in volume and diversity, a need emerged to introduce certain rules of practice. So, the nineteen most active houses operating in the market gathered in 1969, in order to discuss ways and means to institute a more-orderly market mechanism. A common position was easily reached that orderly market functioning could best serve the interests of both banks and investors. Since then, the Association has grown to cover a one-trillion-dollars market, with an annual turnover of US\$ 6 trillion.<sup>191</sup>

ISMA's organization is similar to many other associations, having the General Meeting and the Board at the top, and various committees for particular activities. Among the associations and organizations previously discussed, it mostly resembles the structure of NASD (US). ISMA is organized along two lines: committees and sub-committees are concerned with different aspects of market transactions, such as the finance, membership, market practice; regional committees are organized in order to keep a close touch with regional developments, as well as to have "regional" interests communicated to the Board.

However, besides these "standard" committees, ISMA has established the Council of Reporting Dealers, and a corresponding Committee. Some one hundred of the most active dealers form this Council, whose main aim is to improve the transparency and liquidity of the market. Namely, each potential member has to subscribe to detailed market rules, as regarding trading hours, the size of trades, and transaction reporting. This Council exerts significant influence on the ISMA general policy, particularly concerning recommendations on market practices. In addition, the Council is responsible for publication of the "Weekly Eurobond Guide" - a publication highly praised by market participants because it announces the next-week's transactions on the market. In this way, market transparency is greatly improved, as well as its predictability. One of the sanctions a dealer breaching the rules can face is removal from the Guide.

The Association's main aim is to

"... maintain the balance between the crucial level of innovation and freedom and the level of stability and predictability necessary for investors and borrowers to have confidence. In this context must be set the crucial issue of liquidity. The establishment of a viable secondary market for international securities with associated liquidity is vital."<sup>192</sup>

It is clear, from this quotation, that the basic values which should be protected are freedom, wealth, order and safety. Therefore, the ISMA's statutes defines its basic objectives as follows. Firstly, the Association will work to promote the development of joint positions of members toward salient issues. Secondly, it will work to enhance efficiency and orderly functioning of the market, creating and implementing rules and recommendations to govern the transactions. Thirdly, it will enhance

relations between its members and with related national and international markets. Fourthly, ISMA will provide information and guidance to governments and international authorities concerned with the market activities. So, the Association

"... exists to help the market, not hinder it. As financial legislation develops around the world, it offers a real service by ensuring that the market continues to operate as freely as possible. The self-regulated freedom is in the interests of all concerned."<sup>193</sup>

A review of the ISMA's recent achievements illustrates how successful the Association is. ISMA has established uniform market practices which govern all transactions in international securities between members. It has achieved the harmonization of settlement procedures and the furtherance of cooperation between the market, CEDEL and EUROCLEAR. ISMA has developed a network of regular contacts and information exchange with central monetary authorities in the countries of its members' origin. It has reached an agreement with International Primary Market Association (IPMA) on new rules and regulations governing the primary issues. Finally, it has introduced the TRAX, an industry-wide transaction matching and reporting system for all internationally traded securities.<sup>194</sup>

The Association indisputably falls into the promotive adjustment category of political actors, although it has more-than-average sensitivity to both internal and external demands. As one of its objectives is to develop and maintain joint positions of members in relation to important matters, ISMA is also characterized by frequent and positive internal communication. Internal bonds between its members are easily created and further strengthened by the success of the Association. The latter primarily refers to the Association's efforts to communicate its members' positions to national and international regulators, as well as to its successful promotion of self-regulation on the global scene. ISMA does not frequently adopt new policies toward other actors, most importantly toward government actors. It opposes unnecessary and burdensome regulation, and emphasizes this particularly in relation to supranational bureaucracies (e.g. the European Community). For example, commenting on the EC initiative to establish a new Committee in charge of the whole of the securities market, the Secretary General of ISMA concluded that

"... it may be that we do actually require such a body, which is relatively independent from the Commission, to perform the regulatory role. But if so, then the users of industry services, the industry itself, the self-regulators and the regulators all need to be involved in defining the Committee's objectives... The Committee should be structured in a way that those on it are not just there to represent competing national interests but have a remit to ensure that markets remain efficient and open..."<sup>195</sup>

In short, the Association represents truly a new type of political actor on the global scene. Being definitely international (in its scope of concern) and multinational (as to its membership, liaisons and contacts), ISMA closely follows



the market developments. This equally relates to its structure, actions and attitudes towards the most relevant issues: market efficiency, transparency, safety and regulation. Although ISMA is predominantly oriented to the promotion of market efficiency, it nevertheless takes an active part in debates about the global securities market. Moreover, as a detailed analysis in Chapter Eight will show, norms and rules developed within ISMA can significantly contribute to a better understanding of elements necessary for a prospective global regime in this field.

### 6.2.2.3. International Federation of Stock Exchanges

The International Federation of Stock Exchanges (FIBV) was set up in 1961, and thirty years after its creation it encompassed 40 member stock exchanges from thirty countries, as well as 25 corresponding exchanges. The latter group includes stock exchanges which have not yet been granted membership status (full or associate) but nevertheless keep in close contact.

The FIBV's origins date back to the 1930s, when an initiative was taken by the International Chamber of Commerce to create an International Bureau of Stock Exchanges. This existed until the outbreak of the World War II. In the late 1950s, several European stock exchanges undertook major steps to institutionalize their informal cooperation, as they felt it would be useful both for themselves and for the secondary market as a whole.

The organization of the FIBV features the General Assembly (as the main decision making body), the Executive Committee (in charge of broad policy development and the division of work), the Working Committee (the forum for exchange of information), various subcommittees and workshops, as well as the Secretariat. Frequent communication is encouraged between the members, as well as between the FIBV and other organizations such as IOSCO, the Organization for Economic Cooperation and Development (OECD), Federacion Ibero-Americana de Bolsas de Valores (FIABV), and the Federation of Stock Exchanges in the EC (FSEEC). The FIBV does not just keep in regular contact with these organizations, but it also initiates joint meetings of the Executive Committees, workshops on particular issues, seminars, etc.

Apart from maintaining close liaisons with other relevant organizations, the Federation persistently seeks to make its views widely known and to broaden public support.

"The first priority is the building of international press contacts, as the FIBV wants to position itself as an international organization. Media coverage of FIBV events and opinions should be further developed in order to increase the general awareness of the FIBV, its aims and policy."<sup>196</sup>

The basic aim of the FIBV is twofold and simultaneously focuses on the national and global level: the improvement of securities markets functioning, and

the promotion of self-regulation. This aim is further specified in the following objectives: 1) the promotion of efficient, fair and secure national markets; 2) the promotion of cooperation to establish standards for transnational transactions; 3) the promotion of larger and more liquid capital markets, as well as the balanced development of the market segments (e.g. equity, bonds, etc.); 4) the promotion of self-regulation within the total regulatory framework, and 5) the promotion of ethical behaviour in securities markets. So, the basic underlying values which guide and motivate the FIBV's activities are wealth, equality and freedom (from statutory regulation), and to a much lower degree - safety and order. Nevertheless, recent activities of the Federation, such as the agreed principles on business behaviour, added much more significance to the value of order in the markets.

The FIBV has been active in relation to almost all issues concerning the securities markets, with a surprising exception of investor protection. For example, pertaining to international clearing and settlement, the FIBV has established a special Taskforce composed of FIBV members and representatives of EUROCLEAR, CEDEL, the Group of Thirty and Central Depositories of different countries. This clearly exemplifies the Federation's openness to other actors specialized in particular fields. Yet another example of the FIBV's readiness to cooperate with adequate professional associations is in the field of international securities regulation. Together with the International Bar Association (IBA) and the International Federation of Accountants, it has created the International Capital Market Group. The main purpose of the Group is to consider developments in the global capital market and to make regulatory proposals, as well as to promote investor confidence internationally. A particular attention is therein paid to "world class" issuers and transnational raising of capital. So, the FIBV closely monitors developments on the global level and, similarly to some other organizations, shifts its focus accordingly. As global transactions gain in importance, the proportion of attention being paid to them rises as well.

Self-regulation is one of the FIBV's main aims, and the Federation is by far the most active proponent of the principle on all levels of regulation. It is not only the national-level framework that should rely on self-regulation. FIBV strongly advocates international self-regulatory cooperation and coordination. To support its position on regulatory issues, the FIBV has produced a set of evaluation criteria for international securities regulation. The market-efficiency objective is again underscored as the most important criteria<sup>en</sup>, i.e. any regulation should be market driven, flexible and minimally burdensome (the value of freedom), and at the same time conducive for competition (the value of equality). However, it is recognized that any regulation should assure that transactions are handled fairly and according to the highest professional standards (the value of safety). In addition, any international regulation should aim at reducing "systemic risks to users and participants in the markets and the inter-related global markets system."<sup>197</sup> It is not

often the case that professional organizations take such a broad and comprehensive perspective, perceiving matters salient to them as parts of wider or more general issues.

As mentioned, the FIBV has recently produced a set of conduct principles aimed at promoting the values of order and safety in the securities markets worldwide. The "Generally Accepted Principles of Securities Business Conduct" are a bench-mark for member exchanges in implementing the concept of fair treatment in the markets. A detailed analysis of these and other proposed principles of business conduct will be presented in the following chapter.

A final remark on the FIBV has to be made, which is of a great importance for the course of this study. It is the fact that the FIBV perceives (treats) the members as constituting parts of an international exchange community. Their roles, rights and duties, as well as their common goals and aversions, are therein carefully defined and monitored. This attitude resembles to a high degree a similar perception developed in some of high-status "national" associations (for example, in Britain and Luxembourg). In the case of an international organization, such as the FIBV, the perception of an emerging professional community is qualitatively upgraded. The idea of a non-government cross-border community, which actively lobbies for its interests, is a new ingredient in global political processes. The importance of this novelty is even more accentuated because the FIBV accepts norms belonging to the state-centric world, transcended by such communities.

"Members of an exchange community should conform to the just and equitable principles of conduct embodied in exchange rules and commonly practised in the marketplaces in which they conduct business."<sup>198</sup>

In short, the FIBV is one of the most prominent actors participating in debates about the global securities market place. The Federation incorporates most of the promotive political features, primarily found in "national" professional associations, which here sustain a much wider perspective and a global scope of concern.

### **6.2.3. National authorities**

Regardless of a constant increase in the speed by which global securities integration proceeds, national regulators and authorities still exert crucial political influence therein. The same applies to both national and international debates about the markets, although in the latter case national regulators are confronted with other views and perspectives. Basic regulatory structures in the four most important markets were presented in the second chapter of the analysis. As a background, different national financial traditions were compared in order to put more light on

the origins of distinct approaches to banking and finance that exist today.

Recalling the theory of economics and finance, the ultimate purposes of financial regulations can be formulated as: 1) the prevention of systemic risk, 2) the prevention of an excessive risk-taking by individual investors, and 3) the promotion of systemic efficiency. All regulators worldwide are engaged in a myriad of activities aimed at: maintaining the stability of their financial systems, ensuring the financial soundness of institutions, protecting investors against fraud and undue risks of losses, ensuring a proper working of competitive market forces, etc.<sup>199</sup> However, the level of importance attached to each of these purposes varies to a considerable extent.

Although each country's financial markets have their own peculiarities, two substantially opposed approaches to regulating financial markets can be identified. Concepts such as "prevention", "inspection", "information asymmetry" and "disclosure" are all related to one approach, which can be termed the anxiety approach. Opposed to that is the confidence approach, which subsumes concepts such as "self-regulation", "professional conduct", "regulatory flexibility" and alike. Oversimplifying, the main aim of the first approach is to bring the financial markets under a strict and continuous control, in order to evade failures and losses. On the other hand, the confidence approach stresses individual and social benefits from maintaining a relatively high level of freedom of markets, which are self-regulated. In the first case, "powers" of the financial markets are feared. In the other case, "powers" of the financial markets are relied upon. In the first case, financial forces are suppressed. In the second case, they are channelled and the best use is made of them.

This was an introduction necessary to comprehend a broad social position and general attitudes of national regulators. As a detailed survey in this field would transcend the scope of this study, just three examples are going to be analyzed.

#### 6.2.3.1. The Securities and Investment Board in the UK

The Securities and Investment Board (SIB) was set up in 1988, when the main provisions of the 1986 UK Financial Service Act came into force. Within a new regulatory framework, most of the powers to regulate and supervise the securities market have been transferred to the SIB. The main underlying aim was to introduce an integrated framework which would replace a piecemeal approach that had combined government measures with self-regulation.

The SIB is a private limited company with substantial regulatory powers, but it is not a government department. It is an agency funded by the financial services industry itself, with no contribution from the government. The Board comprises a number of practitioners and experts from the financial sectors, for it has been recognized that knowledge of practice and close touch with the industry are the

essential inputs to any effective regulation. However, there is also a number of independent members of the Board, which represent the users of financial services and the public at large. The importance of SIB is illustrated by the fact that its members are appointed jointly by the Secretary of State for Trade and Industry and the Governor of the Bank of England. So, the securities industry is not seen as an isolated, service segment of the economy. Furthermore, the securities market's role as one of the pillars of economic growth has been emphasized. Although not a government agency, the Board has the obligation to report annually to the Secretary of State and Parliament.

The Board has statute-backed regulatory powers that include: the ability to authorize and restrain investment business, the ability to carry out criminal prosecutions if business has been conducted without authorization; the power to take civil proceedings and issue reprimands, as well as the formal power of investigation with criminal sanctions. Finally, SIB has the power to recognize Self-Regulatory Organizations, i.e. to delegate to them the power of regulation of the investment business carried on by their members. SIB does not supervise only securities firms, but also investment departments of banks, insurance companies and building societies. So, the Board can take a proper view of the whole of the market, regardless of the type of participant.

SIB's main aim is to develop a regulatory framework that equally serves two basic purposes: enhancement of investor safety and promotion of market efficiency. To this end, it is crucial that professional and industry standards are properly set up and widely followed.

"SIB's major aim is to achieve a high level of investor protection and to promote overall efficiency in the financial markets. The system is designed to ensure that those providing any form of investment service, including those who deal in or advice on investment products, meet standards of *honesty, competence and solvency.*"(italics added)<sup>200</sup>

The need for an overall regulatory framework has been recognized explicitly, but the regulation of financial markets must not hinder competition and basic market forces. The regulatory system, as perceived by the Board, has to be flexible enough to be able to react to changes and developments. The latter concerns not just different segments of financial markets, but also links with other markets as well (e.g. commodities markets). The value of safety ranks high, but not to the extent it does in some other financial centres. For example, an Investors' Compensation Scheme has been created, providing for payments of up to 48000 pounds sterling to private investors if an authorized firm goes into default. For that purpose, the SIB maintains high authorization standards for firms, such as consideration of adequacy of financial resources and the previous record of the firm. However, too much of the protection is not seen as beneficial, and the regulatory action cannot be expected to prevent problems caused by market factors.

"The overall aim of the regulatory regime is to ensure healthy, internationally competitive markets in which both users and practitioners can have confidence."<sup>201</sup>

So, as in the cases of the UK banking associations, efficiency of the markets is the top priority - particularly their competitive position in the international system.

The SIB is very open to discussions and cooperation with other SROs, professional associations and international organizations. As has been mentioned, it has joined both international government organizations (e.g. IOSCO) and international non-government organizations (such as the ICSA). The SIB's main attitude to regulation is that it must always rely on a balance between national tradition, local peculiarities, government priorities and the industry needs. This is among the best examples of the confidence-regulatory approach.

"When you design a regulatory system and its specific rules most people would agree that you'd be foolish to ignore a special role that the industry practitioner can play in designing or preventing unworkable regulation... In my view, Government and self-regulation must interact if it's to be good, and co-operative regulation. The correct point of balance is the challenge. Striking balances is really what we have to do as regulators."<sup>202</sup>

Although the SIB was created rather recently, in comparison to the long-standing history of similar agencies in some other countries, it has already positioned itself on the global scene. For example, it occupies one of the two leading roles in the most prominent organization in the field (interchangeably with the US Securities and Exchange Commission): SIB's representatives chair either the Executive Committee or the Technical Committee of IOSCO. In that way, the Board is perceived to be very near the decision-making "heart" of an international regulation process.

In short, the Board epitomizes another new type of actor in debates about the global securities market. It is not a pure government agency, but has been delegated important regulatory powers. Although most of its activities are oriented to preservation of order, basic guiding principles significantly depart from norms and structures of the governmental world. The consideration it pays to the industry needs, as well as the reliance on self-regulation, clearly distinguish the Board from regulators in other countries.

#### 6.2.3.2. The Securities and Futures Authority in the UK

The Securities and Futures Authority (SFA) was set up in 1991, by merging the Association of Futures Brokers and Dealers (AFBD) and the Securities Association (TSA). It is one among four SROs empowered by the SIB to exercise authority in their particular area of financial services.<sup>203</sup> The SFA is responsible for regulating (authorization and supervision of) firms that deal or advise in

securities and derivatives.

SFA has 1400 member firms, and most of them are securities dealers and brokers and advisory firms. Concerning the international composition of the membership, half of the total are UK firms and the rest are firms from continental Europe, US and Japan. So, once again, the UK's high attractiveness to foreign business is exemplified in a multinational structure of local associations and organizations. Once again, it is really the whole of the securities market that is in focus, regardless of national origins of market participants.

The Authority carries out various activities in relation to authorization, monitoring, investigation and prosecution, and enforcement. Authorization of firms is actually the most important part of the regulatory process.

"Firms that seek authorization must provide information which demonstrate that they are adequately funded, have viable business plans, that their management and staff are suitably experienced and competent and that there is no history of malpractice."<sup>204</sup>

So, what is stressed is firstly the need to protect and improve market efficiency (solvency, planning, competence), and secondly to promote safety for investors. Once a firm has been authorized, it has to maintain close contacts with the SFA and provide regular and special information. Above all, the firm has to comply with SFA rules - a new, three-tier, conduct-of-business rules, structure.<sup>205</sup> If a more serious breach of rules is suspected, a more focused investigation is undertaken by the SFA. This is the phase when the SFA becomes very active in using its liaisons with regulatory authorities, both at home and abroad. As it cannot undertake criminal prosecution, the SFA passes results of its investigations to the Department of Trade and Industry, or to the Police.

Practitioner-based self-regulation is seen as the proper way of coping with modern securities markets.

"The aim of SFA is to promote and maintain high standards of integrity and fair dealing in the carrying on of investment business by bringing to bear the detailed *knowledge* and *flexibility* of practitioner based self regulation to the supervision of securities and futures firms and to secure compliance with rules *fairly* and *effectively*." (italics added)<sup>206</sup>

The SFA maintains close links with its membership, to a degree beyond that of most of regulators in other countries. This is specially the case when it comes to concrete issues of a great salience. For example, commenting on the EC proposal for a Capital Adequacy Directive, the SFA International Capital Committee

"... attached considerable importance to consultation with the membership, and the Chairman of the Committee wrote to all firms on two occasions to *inform* them of developments, to *highlight* issues of concern and to *solicit* their views..."<sup>207</sup>

Furthermore, the SFA does not just endeavour to reach a joint position among its

members, but also extensively uses its public relations and links to authorities (at home, abroad and international) to communicate its views effectively. In the case of international government organizations, where it is not directly represented, the SFA works in close coordination with the UK representatives (e.g. the SIB).

#### 6.2.3.3. The Securities and Exchange Commission in the US

The US Securities and Exchange Commission (SEC) was founded by Congress in 1934, under the provisions of the Securities and Exchange Act. It is described as an independent, non-partisan, quasi-judicial regulatory agency. Its foundation was laid in an era which was particularly ripe for reform: there was the Great Crash of 1929, a great number of publicized financial scandals, as well as numerous cases of market malpractice revealed by the so-called Pecora Committee.<sup>208</sup>

"The revelations of the Pecora Committee rival the revelations of the modern-day Watergate investigation in terms of the public attention and demand for reform to which they led."<sup>209</sup>

It was in a time of economic instability and political change when public desire for financial reforms actually laid the foundations for a new regulatory regime. SEC became one of the pillars of the regime. One must take a broader historical view on the circumstances that prevailed, in order to understand fully the SEC's mission. It was the fear of the market, its powers and mechanisms, that underlined the passage of the 1933 Securities Act - called "truth in securities" legislation. The main axiom has been that if information is properly (evenly) distributed among market participants, the market will perform its functions most efficiently (the Efficient Market Hypothesis in economic theory). After the disastrous experience of the early 1930s, already-existing lack of confidence in markets was further exaggerated.

So, the SEC's main responsibility has been to exercise control and supervision of the market in a way which would provide protection for investors. More specifically, its mission has been to administer federal securities laws, most of which were passed during the 1930s and 1940s.<sup>210</sup>

"The purpose of these laws is to ensure that the securities markets are *fair* and *honest* and to provide the means to enforce the securities laws through sanctions... These laws were designed to facilitate informed investment analyses and decisions by the investing public, primarily by ensuring adequate disclosure of material (significant) information."<sup>211</sup> (italics added)

The Commission carries out its work, both in its Washington headquarters and in regional offices, through four divisions and offices charged with specific responsibilities. The Commission itself is composed of five Commissioners, whose appointment has always been a highly politicized matter. One of the rules, rather unique among regulators worldwide, implies that no more than three of the



Commissioners may belong to the same political party. The Commissioners are concerned with matters such as interpretations of laws, amendments, new rules, actions to enforce the laws and discipline, etc. Their work is supported by the staff, which grew in size over 20 times during sixty years of the SEC's existence.

The SEC's main activities are primarily oriented toward supporting the values of order, safety and equality in the market. It is concerned with information disclosure in primary distribution (securities registration), disclosure for publicly traded firms (financial statements of issuers), control of secondary markets (rules for conduct on the stock exchanges), insider activities, corporate governance, anti-fraud regulation, and control over investment companies. So, promotion of market order and investor safety have for a long time been the SEC's only preoccupation. However, as certain market developments (e.g. the emergence of "third" and "fourth" markets) were occurring in the beginning of the 1970, it became obvious that regulation was falling behind the reality. Promotion of competition in securities markets and enhancement of their efficiency gained in importance. It has been realized that strict control and safety standards should not be the only values to guide the work of SEC. As capital started to flow out from the US (in order to avoid this strict control), the value of wealth and efficiency goals ascended on the agenda. In 1975, SEC was mandated to facilitate the development of a National Market System - an automated auction market for all outstanding securities.<sup>212</sup> An example of the pre-1975 SEC's attitudes is the interpretation of trading and sales practices (1934 Securities Exchange Act):

"These provisions seek to curb misrepresentations and deceit, market manipulation, and other fraudulent acts and practices. They also strive to establish and maintain *just and equitable* principles of trade conducive to maintaining *open, fair and orderly* markets."<sup>213</sup> (italics added)

The Commission is among very few regulators that maintain such an authoritative posture toward the securities industry. In striking contrast to, for example, the UK Securities and Futures Authority, the SEC takes due care that the decisions and rules are flowing from the top down, and that information is constantly flowing upwards. It is always emphasized that the SEC is an independent agency, i.e. a non-governmental body. However, it often acts not an agency for the securities industry - but an agency "over" the industry. So, it could also be described as "independent" from the industry itself.

SEC exemplifies a high-status political actor, having in mind a wide range of powers delegated to it and diverse means to achieve its mission. As its main goal has been to control the market, the speed and depth of the financial revolution has been perceived (by SEC) as the most important threat to its work. A feeling of high value-deprivation is sometimes very obvious:

"The 'Brave New World', as Commissioner James Treadway termed the changing and rapidly growing financial service industry, is the biggest issue

facing the Commission - and one which is beyond its control."<sup>214</sup>

It is not only unforeseeable market developments that are felt as threats. Certain measures in the field of international regulation are also seen as jeopardizing the SEC's role and status. That is the reason underlying a very cautious approach of SEC towards supranational regulation.

"We have to be prepared to take whatever time it takes to work out the problems with new standards before we inflict them on markets, not afterwards. Capital standards in particular can have significant unintended results, like the immense reduction in commercial lending by banks in the US that has been at least in part caused by the Basle capital standards for banks."<sup>215</sup>

SEC is definitely among a very few highly-influential actors participating in debates about the global securities market. The Commission is so well positioned on the scene that its views are most effectively communicated to other participants. For example, its chairman also chairs the IOSCO Technical Committee, which deals with matters of an essential importance for the global securities market.<sup>216</sup> Although it almost never enters into formal agreements with other actors, it maintains direct, informal contacts with regulators and professional associations abroad.

Although the macroeconomic conditions that surrounded the SEC's creation <sup>were</sup> are by no means similar to the present-day environment, the Commission has maintained some of its basic features.

"Regulatory bodies, like the people who comprise them, have a marked life cycle. In youth they are vigorous, aggressive, evangelistic, and even intolerant. Later they mellow, and in old age - after a matter of ten or fifteen years - they become, with some exceptions, either an arm of the industry they are regulating or senile. The SEC was especially aggressive, and the Wall Street was certain to seem a challenging antagonist."<sup>217</sup>

The uniqueness of SEC relates to the fact that, over a long period of existence, it has neither become senile, nor an agency for the industry. In the beginning of the 1990s, SEC is even more assertive in continuing to protect the values of order and safety - as the emergence of the global securities market is yet more of a challenge than the chaos of the 1930s.

#### **6.2.4. International organizations**

This group of actors is a very diverse one, as it comprises international organizations (or more precisely, committees of such organizations, which deal with financial regulation) and various regulatory groups formed on different supranational

levels. Basically, these are intergovernmental actors, but it also includes a new type of political actor on the global scene: international quasi non-governmental organizations.<sup>218</sup>

"An *iquango* is an international organisation which includes in its membership *both* government departments and/or other governmental institutions *and* single-country, non-governmental organisations and/or multi-country, international non-governmental organisations."<sup>219</sup>

Two examples of iquangos are included in this study: the International Organization of Securities Commissions (IOSCO) and the International Councils of Securities Associations (ICSA). Neither of them is a pure international non-governmental organization (though that has been permanently stressed by the IOSCO Secretariat and by some authors<sup>220</sup>), nor a "classical" intergovernmental organization, established by an agreement among governments. IOSCO comprises "national" authorities concerned with securities regulation. The ICSA has self-regulatory organizations, an international self-regulatory association and several trading associations as its members. As illustrated, sometimes national securities regulators are highly independent from their governments (both in respect of decision-making and funding). In other instances, regulators are indeed government departments. Yet in other cases, regulators of the securities industry are formally government-independent, but actually serve as an "arm" of the government. In general, most of the regulators are considered to be "independent agencies" or "independent regulatory commissions". Such bodies are freed from full administrative control from their governments, and perform quasi-judicial and regulatory functions in connection to one or several industries. They are sometimes labelled as "quangos", in order to stress their broad regulatory powers and a relatively-high level of autonomy.

However, most of these regulatory bodies have been founded by their governments, and are still responsible to corresponding ministries or government departments. Most often, chairpersons of such bodies are appointed by the president or the government. For example, the US president designates chairmen of SEC, who play strong leadership role. The SEC's proposed legislation, budgets and litigation are reviewable in the Senate. In the UK, members of the Securities and Investments Board (SIB), including its executive chairman, are appointed jointly by the Secretary of State for Trade and Industry, and the Governor of the Bank of England.<sup>221</sup> Having in mind a diversity of the both IOSCO's and ICSA's membership (which will be discussed in the following section), as well as still theoretically ambiguous nature of "independent regulatory commissions", it can be concluded that the two represent a new type of political actor - iquangos.

The diversity of the group accentuates not only different nature of the actors, but also a wide scope of routes that can be taken by single-country actors in order to achieve a preferable disposition of stakes. For example, the regulators from the

UK participate directly in debates carried out within: IOSCO, the G-10 Basle Committee, the EC Banking Advisory Committee, the Banking Supervisory Sub-Committee of the Committee of Governors of the EC central banks, the OECD Committee on International Investment, the OECD Committee on Capital Movements and Invisible Transactions, the UN Commission on Transnational Corporations, and the GATT Group for Negotiations on Services.

This group also exemplifies a varying degree of political status the analyzed actors enjoy, as well as the different scope of their concerns. For instance, the UN Commission on Transnational Corporations deals with more general matters, like a code of business conduct, which are nonetheless related to the global securities market. It is by far much less influential than certain organizations or regulatory groups "specialized" in the securities markets. Different committees from the intergovernmental organizations, such as the OECD and EC, also enjoy a rather high status, but their scope of concern is neither "general" (as of the UNCTC), nor global (as of IOSCO). These committees emphasise certain concrete stakes, such as the authorization of market entry, but always from the perspective of a broader organization. In addition, certain actors place the debate on the global securities market within the context of other hyper-issues (e.g. regulatory groups from developing countries, within the context of development).

It might seem unreasonable, at first, to cluster such different actors under the same heading. However, what gives them common characteristics is the fact that they all actually epitomize different answers of the intergovernmental world to an emerging global issue. The proliferation of forms and modes of these responses indeed justifies the choice of Global Politics as a theoretical framework for this analysis. Regulation of the securities market has become an issue of an extremely high salience for many actors, although not being in the realm of the classical "high politics". National interests are perceived as being seriously affected by global capital flows, but the archetypal state weapons seem rather irrelevant. Moreover, integration processes have generated many new opportunities for communication and political manoeuvres.

#### 6.2.4.1. International Councils of Securities Associations

The International Councils of Securities Associations (ICSA) was formed in 1988, under the name "International Councils of Securities Dealers and Self-Regulatory Associations". This organization still endeavours to establish itself as an actor on the global scene, by trying to widen the membership and make its views more effectively communicated to regulators and public. Although not being among the most prominent actors, the ICSA certainly deserves to be included in this survey. The primary reason for that lies in its rather unique membership composition: the ICSA equally encompasses both professional associations and self-

regulatory bodies. It epitomizes one of the most important institutional links which is definitely going to gain in relevance, as global financial expansion continues and regulatory problems mushroom.

Originally, the organization was composed of two councils: the Council of Self-Regulatory Associations and the Council of Securities Dealers Associations. The first represented organizations with regulatory authority over their members under the laws of their domiciliary country. The second Council encompassed professional and business associations and organizations.

"It was formed in 1988 out of the growing internationalization of securities markets and the need to establish harmonious, efficient systems to operate and regulate cross-border trading of securities."<sup>222</sup>

So, promotion of market efficiency was seen as one aim, and development of an adequate cross-border regulation as another aim, separate from the first one. For that reason, the organization was composed of the two Councils - on the assumption that these two aspects of the global securities market (efficiency and regulation) have to be dealt with separately. At least, it was assumed that regulators have one group of motives in common, and business has another. However, as issues related to international transactions grew in complexity and their interlinking, it became obvious that any kind of "separation" between the actors involved could hamper both basic aims. The need for a closer cooperation between the industry and regulators led to abandoning the original structure of the organization.

In 1992, the organization comprised 11 members: three self-regulatory organizations (from Canada, the US and Britain), one international self-regulatory association (ISMA), and seven independent professional associations from the industry. In some other international organizations concerned with the global securities market (e.g. IOSCO), these different types of actors do not have an equal status as they do in the ICSA. For example, this is the only international forum where British Merchant Banking and Securities Houses Association and the UK Securities and Futures Authority have equal voice. However, besides placing the regulators and professionals around the same table to discuss international issues, the ICSA provides an environment conducive for development of new links between them. So, for example, these two types of actors can communicate more effectively also on issues not transcending the UK borders. In addition, they can more easily develop a joint position on issues relevant for the preservation of the UK position in world finance.

The main aim of the organization is the promotion of the sound growth of the international securities markets and the facilitation of international transactions. This basic aim is further specified through two objectives: encouraging harmonization in the procedures and regulation of the markets, and building a joint members' position toward salient issues. A great importance is attached to the second objective, so the ICSA permanently works on establishing frequent

communication (internal and external), promoting mutual understanding, and on sharing and exchanging of information between the members. One of the concrete goals, albeit not explicitly stated, is that members should build the contacts with their respective home-country governments in a way that would enable them to lobby effectively for the global growth of the securities markets. An illustration for this can be found in a statement of the Chairman of the Korean Securities Dealers Association, made after it had been welcomed as a new ICSA member.

"I assure you that I will do my best to perform the role and responsibility as an ICSA member and to closely coordinate with our government authorities in further expanding the depth and width of our securities market internationalization both with respect to permitting increased international investment in Korean securities and expanded access for foreign securities professionals to the Korean securities markets."<sup>223</sup>

Concerning international regulation of the securities markets, the ICSA takes the position that it must not develop as an impediment for the global growth of the markets. Furthermore, any harmonization must be undertaken gradually and within a broad international context.

"In promoting the development of global capital markets and securities business, we must continue to cooperate in *preventing* regulations from becoming obstacles to these goals. At the same time, it is necessary to coordinate on a global basis the necessary regulations for securities transactions and business. For this purpose, ICSA must work actively and effectively to support IOSCO. (italics added)"<sup>224</sup>

Having in mind these postures taken by the ICSA, it is not surprising that certain rather "conservative" regulators (for example, from the US and Germany) are far from participating in the Councils. So, what the ICSA actually represents is a small, but fairly united, front on the global scene that presses toward preserving a relative freedom of the global securities market. A unique feature of the organization is that it comprises actors according to their basic orientation, but regardless of their status, influence, internal organization or powers delegated to them in the home countries. The protection of the value of freedom underlies all the actions, but not the freedom from all regulation. The imposition of order is actually a prerequisite for the efficient global development of capital markets, but only as long as it does not impinge on basic market forces.

#### 6.2.4.2. International Organization of Securities Commissions

The International Organization of Securities Commissions (IOSCO) is unquestionably an institutional centre of debates about the global securities market. The first IOSCO Annual Conference was held in Venezuela, in 1974. In 1987, IOSCO was legally incorporated as a non-profit organization, headquartered in

Montreal.

In 1992, IOSCO had 92 members representing 60 countries. Its membership is divided into three categories: 1) regular members (national authorities) with voting power; 2) associate members (some trading associations) which do not vote, but are eligible for the Presidents Committee, and 3) affiliate members (stock exchanges, professional associations and international organizations) which are only eligible for the Consultative Committee. The first group is highly diversified and comprises securities commissions, banking supervisors, financial authorities, central banks, ministries of finance, stock exchanges and associations of stock exchanges. The representative body of each country is chosen according to its regulatory structure. What is of a great significance for this analysis is the composition of the third group of members. The affiliate members include stock exchanges, derivative exchanges, associations of exchanges and associations of dealers, but also representatives of the Commission of European Communities and OECD. In addition, some self-regulatory organizations are also represented, for example the International Securities Market Association.

So, all types of actors are represented in IOSCO: governments, government agencies, self-regulatory organizations, international governmental and non-governmental actors, individual market participants and their associations. Besides, all market segments are "covered": securities and derivative instruments. IOSCO's central role in debates over the global securities market is due to, inter alia, these two features of its membership: all types of actors are there, and they represent or regulate all major market segments. Although national commissions form the "core" of the Organization and vote for strategic decisions, IOSCO is very open for consultations with other actors. What is even more important, all the affiliate members have equal status regardless of their nature. So, for example, the Chicago Mercantile Exchange has a same say as the OECD or the EC representatives.

The Presidents Committee is at the top of IOSCO's organizational structure, and is made up of all the presidents of member (regular and associate) agencies. It elects the Executive Committee, which in addition comprises representatives from the Regional Committees (Interamerican, European and Asia-Pacific Regional Committee). The work of the Executive Committee is supported by two specialist bodies. The first one, the Technical Committee consists of the securities agencies that regulate the most developed markets in the world. It is concerned with the matters most essential to the global market: multinational issues, disclosure and accounting; regulation of secondary markets and intermediaries; exchange of information, etc.

The second specialist body is the Development Committee, which endeavors to promote the development of emerging securities markets. It has identified the three priority areas: market incentives, clearing and settlement, and internationalization experiences and disclosure.

So, IOSCO is structured along the two lines: a regional and a developmental one. The existence of the two structuring criteria emphasizes its truly global scope of concern. Certain problems and matters relevant to the securities markets originate from each country's historical background, culture and tradition. There are also problems derived from regional integration processes. For that reason, common interests and aversions can more easily be identified among countries belonging to the same region. For example, a cautious approach toward opening financial markets is widely shared among many countries in the South-East Asia. Yet other important matters are closely related to the level of market development and sophistication. For example, regulators of emerging markets are much more concerned with attracting foreign investors than with supervising global securities issues. This two-fold problem approach enables IOSCO to take the broadest possible perspective over arising stakes. In addition, affiliate members bring in their own perceptions - for instance, the industry's point of view. In this way, it is easier to identify common denominators, i.e. to cluster issues within distinct issue-dimensions. Hence, adequate policy packages can be created and negotiated, as well as concrete policy measures.

Having in mind that IOSCO is actually a set of regulators, it is surprising how its main objectives are ranked.

"The member agencies have resolved: to cooperate to ensure a better regulation of the markets, on the domestic as well as on the international level in order to maintain *just* and *efficient* securities markets; to exchange information in order to promote the *development* of domestic markets; to unite their efforts to establish *standards* and an effective *surveillance* of international securities transactions..."<sup>225</sup> (italics added)

So, for the Organization as a whole (as interpreted by its Secretariat), the values of equality and wealth are perceived as being the most important to be promoted. The value of development is emphasized as a separate value, although some of its content can also be subsumed under the value of equality. For example, some of the norms that accentuate the right of developing countries to participate in the creation of a global environment favourable for their emerging markets, or sharing of developed markets' experience, can also serve the promotion of equality among market participants. Finally, the value of order is underscored by recognizing the need to establish a common framework for supervising domestic and cross-border transactions.

When the analysis is focused on the IOSCO Committees, however, different accents are put on the underlying, basic values. The Executive Committee, for example, perceives IOSCO as the major international forum for collaboration on regulatory issues. Its broad aim is to

"...facilitate the efforts of national regulators in ensuring that such business is conducted by adequately capitalized firms through safe and sound market systems, with investors afforded proper protection."<sup>226</sup>



So, system soundness (adequate capital base of firms) and investors' safety should primarily guide the work of IOSCO.

The Technical Committee, on the other hand, places much more emphasis on creating a comprehensive and stringent system of market regulation and control. From this point of view, IOSCO is seen as a forum that gathers experts to review regulatory problems and propose practical solutions. Apart from recognizing the impact of global integration, national laws and national regulators must maintain autonomy and the largest body of responsibility. So, IOSCO should serve to reach a consensus among regulators:

"For the future, our work will hopefully continue to be useful in functioning as a 'clearinghouse' of ideas and techniques of members around the world. As the world we live in becomes perhaps a bit more uncertain, it becomes all the more important to share early warnings of problems and solutions that work or don't work with each other. However, if the Technical Committee were to be used to try to force the attitudes of some markets onto others, the result would be unfortunate and unproductive."<sup>227</sup>

The Consultative Committee (made up of the affiliate members) sees IOSCO as a vehicle for cooperation in the securities regulatory field, but not just cooperation among government (statutory) regulators. Such a prominent international forum should serve the promotion of self-regulation, and of cooperation between the government and self-regulatory agencies.

"Self-regulatory organisations are natural and important parts of the securities regulatory system. Regulatory cooperation between government regulators and self-regulators is essential to successful regulation. Cooperative regulation is highly desirable, and in IOSCO one aspect of that regulation can be achieved by allowing self-regulators early opportunity to *respond* and to *influence* proposed IOSCO substantive regulatory policies."<sup>228</sup> (italics added)

From this perspective, IOSCO should create an environment favourable for developing closer contacts between the industry itself, its own regulatory structures and government agencies.

IOSCO is concerned with many aspects of the securities industry's functioning and regulation, at both the national and the global level. Its major recent activities include: 1) a proposal on capital adequacy standards for securities firms; 2) a set of principles ("Memoranda of Understanding") which should foster reciprocal assistance among members on market oversight and the prevention of fraud; 3) the Rio Declaration, that calls on signatories to provide assistance on a reciprocal basis in the gathering of information for market supervision; 4) the resolution on the principles for the oversight of screen-based trading systems for derivative products, and 5) the resolution on international principles of business conduct.

For the course of this study, the first and the fifth group of these activities are of a great importance. The Memorandum on Capital Adequacy Standards of the Technical Committee was addressed to the Basle Committee on Banking Supervisors. It sought to clarify and improve (or even amend, where necessary) the Basle proposals, regarding minimum levels of capital for internationally active securities firms and banks. It has to be pointed out that in January 1992, for the first time, the IOSCO Technical Committee and the Basle Committee held a joint meeting to consider proposed capital rules, to achieve preliminary understandings and determine forms of the future cooperation.<sup>229</sup> Both sides have recognized efficiency benefits which should be derived from eliminating the competition between the frameworks. If the market is going global, so must the regulation as well. If the distinctions between different market sectors are blurring on the global level, separate / parallel regulatory frameworks can either induce an overregulation or open loopholes. In either situation, the efficiency goal is hampered.

In 1991, IOSCO adopted the Resolution on international conduct of business principles, expressing basic standards of business conduct for financial firms. The IOSCO members were called on to recognize, implement and promote the following principles: a) honesty and fairness, b) best service, c) capabilities, d) information about customers, e) information for customers, f) conflicts of interest, and g) compliance.<sup>230</sup> It has been realised that not all of a firm's activities and attitudes can be regulated ex ante. For example, regulation cannot "foster" or "encourage" a firm to act in the best interest of its customers. Regulation can act ex post, after certain rules (professional standards or legal rules) have been breached. So, the purpose of these principles is to stimulate the development of a general market environment that would not be conducive for fraud, malpractice, sloth and incompetence.<sup>4</sup> A very similar set of business principles has been recently adopted by the International Federation of Stock Exchanges (see above).

So, IOSCO is a top-status actor in debates over the global securities market. It is indeed a global actor, regarding the scope and structure of its membership, but also the scope of its concern. IOSCO is very open for communication and negotiation with other actors, regardless of their position on the scene. It cooperates with the Basle Committee, but also with, for example, the International Federation of Accountants, the International Standards Organization, the Group of Thirty, etc. IOSCO is highly sensitive to both internal and external demands, and is very active in maintaining proper communication channels. It is permissive to internal changes, and even allows different interests of different members to be put forth. IOSCO fully recognizes the complexity of global market structures, and that is the reason behind including intergovernmental organizations in its membership. However, norms and principles of the intergovernmental world are still upheld. Even though

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<sup>4</sup> These principles will be discussed in Chapter Seven.

the members should implement "Memoranda of Understanding" for better supervision of markets, one of the principles recognizes the right of the requested authority to refuse to provide assistance on public policy grounds. Nevertheless, IOSCO does create an environment wherein government bodies and other-than-government agencies can directly communicate.

#### 6.2.4.3. Basle Committee on Banking Supervision

The Basle Committee on Banking Supervision (formerly the Basle Committee on Banking Regulations and Supervisory Practices) was originally set up by the G-10 governors<sup>231</sup> in December 1974. In 1992 it comprised representatives from twelve countries.

The progressive internationalisation of financial markets, during the early 1970s, added to the need for deeper understanding and cooperation among central banks of the main developed countries. As early as 1971, concerns about the evolution of external currency markets led to the establishment of the Eurocurrency Standing Committee of the G-10 central banks. Experience in this field, as well as the failures of the Herstatt Bank (Germany) and the Franklin National Bank (US) in 1974, prompted the authorities to strengthen their cooperation. As international banking was expanding, the Basle Committee was gaining in significance and positioned itself as the centrepillar of international regulatory efforts. The collapse of the Banco Ambrosiano in 1982 (discussed in Chapter Four) gave a strong impetus to the work of the Committee. Having in mind that the Committee was created by the authorities from the most developed markets, it not surprising that its activities and proposals attracted world-wide attention. Although its work is carried out in the Bank for International Settlements, the Committee has no formal links with the Bank.

The work of the Committee encompasses three main areas: 1) it is a forum for communication and discussion over specific supervisory problems; 2) it coordinates the sharing of supervisory responsibilities among national regulators; and 3) it works toward enhancing standards of supervision, in order to strengthen the soundness and stability of international banking. So, the Committee is not just to provide direct contacts among regulators, but also to establish the division of labour and standards and procedures for cross-border supervision.

The Committee's first task was to draw up a set of principles governing the supervision of banks' foreign establishments. The initial document was agreed upon in 1975, and it came to be known as the Concordat. These arrangements, revised in 1983, took the form of recommended guidelines for best practice (not minimum standards). The essence of the document is in the assignment of supervisory authority to the appropriate government, so that the responsibility is shared among the host- and the home country.<sup>232</sup> The assignment of supervisory responsibility

applies to three types of banking institutions (branches, subsidiaries, and joint ventures) with respect to three factors (solvency, liquidity, and foreign exchange operations and positions).<sup>233</sup>

In 1990, a supplement to the Concordat was issued, regarding information flows between banking supervisory authorities. It seeks to provide practical guidance for permanent contacts and collaboration among regulators. The Concordat was supplemented again in July 1992, in relation to supervision of banking groups (which can include, besides banks, other financial and non-bank entities). The responsibility for supervising international banking groups rests with a home-country authority, and the creation of these groups should receive the prior consent of both home and host countries. The 1992 Supplement also stresses the right of authorities to gather information from cross-border groups, and their right (but not the obligation) to impose restrictive measures upon such groups.<sup>234</sup>

Another important document agreed upon is the 1988 Capital Accord, officially entitled "International Convergence of Capital Measurement and Capital Standards". It sets out the details of the agreed framework for measuring capital adequacy (assessing a bank's capital in relation to credit risk), as well as standards to be achieved over certain period of time.<sup>235</sup>

The Capital Accord certainly represents the most significant agreement concerning financial markets reached among the most developed countries. It emphasizes a relatively high degree of consensus among the most influential regulators, in respect to a general approach towards the global financial market place. As described by the Committee's former chairman, Peter Cook, this agreement

"... is only a staging post - albeit an important one - in a continuing process. The Committee's agreed paper is thus rather the end of the beginning than the beginning of the end on this subject... It may be reasonably regarded as a significant milestone in the establishment of a common supervisory response to the existence of a *single*, highly competitive, international banking market."<sup>236</sup>

It was necessary briefly to overview major achievements of the Committee's work, in order to illustrate its general posture towards developments on the global financial scene. Basic values sought to be protected are undoubtedly the ones of safety, order and equality. Particularly in contrast to IOSCO, there is almost an absolute lack of attention paid to issues such as market efficiency, competition, market barriers, integration of emerging markets, etc. The system soundness and stability are perceived as being crucially dependent on an adequate regulation and continuous supervision. Moreover, governments are regarded as being able to exercise such a control, either unilaterally or in coordination with other governments. Norms and principles of the intergovernmental world are strongly upheld, particularly concerning the highest level of policy- and decision-making.

The 1990 Basle Concordat Supplement, for example, is

"... designed to encourage more regular and structured collaboration between supervisors, with a view to improving the quality and completeness of the supervision of cross-border banking, while not in any way seeking to *supplant* the discrete responsibilities of host and parent supervisors."<sup>237</sup> (italics added)

Although the Committee fully recognizes the need for cross-border cooperation of regulators, it however allows the existence of certain "reserves" a country can put on this cooperation.

"It is recognized that parent authorities cannot always be expected to communicate potentially damaging information about the difficulties of a parent bank, disclosure of which would hinder the restoration of confidence... Another possible obstacle is the existence of national secrecy laws designed to protect the legitimate interests of bank customers."<sup>238</sup>

So, the cooperation should be developed but only to the extent where it does not put in jeopardy certain "higher" national goals (for example, macroeconomic stability and confidence in the financial system affecting it). The Committee's attitude of respect for the intergovernmental world are evident especially when it comes to practical collaboration and implementation of agreements. For example, the 1988 Capital Accord stresses that the agreed standards need to allow flexibility of implementation according to differing legal and structural circumstances across countries.

Having in mind that the Committee is composed of representatives of the main developed countries, wherein the great majority of international banks are parented, it is not surprising that parent authorities' rights are strongly advocated. The 1983 Principles for the supervision of banks' foreign establishments, for example, have opened the possibility of extraterritorial reach of parent authorities.

"It is the responsibility of the parent authority to ascertain whether the host authority is able to undertake adequate supervision... In cases where host authority supervision is inadequate the parent authority should either *extend its supervision*, to the degree that it is practicable, or it should be prepared to discourage the parent bank from continuing to operate the establishment in question."<sup>239</sup> (italics added)

The Committee is reluctant to suggest any form of radical changes, particularly if that would result in the creation of new, supranational bodies or fora. In the case of international banking groups, for example, it would be neither adequate nor sufficient to form cross-border groups of regulators.

"Another lesson from the [BCCI] affair is that the 'college' concept is not a full substitute for a clearly designated lead supervisor who can effectively monitor the worldwide operations of a complex group."<sup>240</sup>

The Committee has become one of the most influential international fora

dealing with financial regulation. The impact of its proposals and the agreements reached, extends well beyond the Group of Ten countries - founders of the Committee. For example, members of the Offshore Group of Banking Supervisors<sup>241</sup> have also subscribed to the Basle Concordat, as well as a number of other countries. On the industry side, banks have put a lot of effort by themselves to strengthen their capital base.<sup>242</sup> Proposals and "papers" submitted by the Basle Committee have always been the most important ones to be discussed at the bi-annual International Conferences of Banking Supervisors.<sup>243</sup>

Another characteristic of the Committee is exemplified by its desire to achieve high value satisfaction. The protection of values of order and safety is sought through a two-fold approach to banking regulation. On one hand, the Committee works toward creating a global environment that is conducive for effective financial supervision and control.

"This overview of some of the current initiatives of the Basle Committee is interesting in its own right, but to the community of supervisors its value should lie not in its specifics but rather in the message that those specifics are conveying about the broad environment in which we must discharge our responsibilities... It is important that we have a vision as to what may lie ahead as we seek to adapt our ideas and our ideals in a manner that is sensitive to the past but alert to the future."<sup>244</sup>

On the other hand, the work of the Committee has widened to encompass many stakes outside the two "original" areas (consolidated supervision and capital adequacy). Some of the recently covered matters include: limits on large exposure, measuring and managing liquidity, the supervision of financial conglomerates, netting arrangements for interbank settlements, and regulatory proposals for securities firms. From the Committee's point of view, they all serve for the realisation of the same two values - order and safety, hence they would form an issue-dimension.

Although the Committee has been primarily oriented to the supervision of commercial banking, it has nevertheless entered debates about the global securities market. Its approach to this hyper-issue will be examined more closely in the following chapter. However, what is important for this part of the analysis is the Committee's role in preserving structures of the intergovernmental world.

It has been creating a general surrounding for the community of regulators to exercise control, and has been simultaneously dealing with a number of concrete stakes. Although its proposals are not legal minima, the Committee's reputation actually enforces a worldwide compliance. In this way, the Committee has seized a position which assures itself that no other actor (or group of actors) can seriously affect the ranking of values it advocates.

#### 6.2.4.4. Other international groupings

Whether it is a universal organization such as the UN or it is devoted to regional integration such as the European Community or the SEANZA forum, many intergovernmental organizations have set up a committee or a commission to deal with global financial markets. A feature that distinguishes them from other actors on the scene relates to their less-than-global scope of concern. Most often, the main attitudes and goals are set within a global framework interpreted at the organization's level. They are important structures for political processes at the organization's level. Regarding global debates, they definitely add another perspective, the one of international organizations as political actors per se. With the probable exception of the EC committees, they take neither a very broad nor a very detailed approach to international financial matters. These actors frequently limit participation in debates to a group of stakes, which they perceive as being salient for the realisation of the same values. These activities, however, need to be included in this survey as they underscore a multiplicity of channels being created - among national regulators themselves and among various groups of national regulators on the global level.

As publicly available information from international fora (e.g. IOSCO and the Basle Committee) and international regulatory conferences do not reveal many details about the participation of these actors, basic attitudes will be exemplified by an overview of their recent activities. The scope of this overview allows for the inclusion of only few actors, which are nonetheless very influential in the debate over securities markets regulation.

##### a) The EC Banking Advisory Committee

Following the 1985 White Paper, the Commission of the European Communities aimed at creating a new policy and an adequate framework for, inter alia, the free movement of financial products. It has been realized that one of the major components of the Single European Market and the European financial common market is related to financial services. It was necessary to liberalize operating conditions for financial services, but also to give consumers access to the best possible service throughout the EC. In 1988, the Commission decided to proceed with the full liberalization of capital movements.<sup>245</sup> Concerning the liberalization of banking services, it was decided to work, already in the early 1970s, towards harmonizing the rules governing credit institutions. Hence, the First Banking Directive was adopted in 1977, and the principle of home-country control introduced. The Second Banking Directive was adopted in 1989,<sup>246</sup> inaugurating the single banking passport and new provisions on the minimum capital required by

credit institutions.

Concerning the securities markets, in June 1992 political agreement was reached on the contentious elements of the Investment Services Directive<sup>247</sup>. Once adopted, the Directive will parallel the Second Banking Directive, setting minimum conditions for authorizations and the single "passport". The proposed Capital Adequacy Directive<sup>248</sup> will complement it by establishing the minimum capital requirements for both banks and investment companies carrying out investment business.

In such an environment, the Banking Advisory Committee (BAC) has a very active role to play. It was set up by the 1977 Directive, and comprises three representatives from each of the bodies responsible for bank supervision in the Member States. The BAC works in close cooperation with the Contact Group of EC Supervisory Authorities, and they jointly follow the implementation of the Directives. It also performs a role of advising the Commission on new proposals, and gathering comments and proposals from the public. To fulfil this role, the BAC maintains close liaisons with national regulators and self-regulatory organizations (both national and international), as well as with banking federations and associations. Finally, the BAC works toward additional coordination of banking legislation at the EC level, concerning deposit protection schemes, large exposures, consolidated supervision and capital adequacy for securities houses.

The BAC is open for cooperation with other actors, for example with the Basle Committee and IOSCO, on equal terms. However, it takes the view that stricter rules should be imposed on investment banks regarding their capital base. This somewhat reflects a fear, widespread among some of the EC members, that European investment banking is more vulnerable to competition from the outside (particularly from US securities houses). Nevertheless, the BAC does not propose strict rules in relation to supervision of market functioning, e.g. reporting and transparency. When market efficiency is suspected to be hampered due to publication requirements ("exceptional market conditions"), the authorities may delay or suspend the requirements. More flexible rules may be drawn up by the authorities for bond trading as well.

In relation to consolidated banking supervision, the BAC takes a rather different view from the Basle Committee.

"There was also agreement in favour of the principle that the competent authorities supervising different types of financial institutions should be *free* to exchange information for prudential purposes on condition that this is dealt with in a confidential manner and that there is *reciprocity*."<sup>249</sup> (italics added)

So, it is even more up to the governments to decide whether to disclose information or not. The principle of reciprocity is reiterated through all major documents, and this definitely emphasizes a positive posture taken regarding prospective regime



formation.<sup>250</sup> Safety and, to a much lesser extent, efficiency are seen as the basic values to guide all the activities.

#### b) The Banking Supervisory Sub-Committee

The Banking Supervisory Sub-Committee was established by the Committee of Governors of the EC central banks in 1990, in accordance with the recommendations of the Delors Report<sup>251</sup>. As Stage One of the plan for Economic and Monetary Union requires the completion of the European financial area and the complete liberalization of capital movements, it has been necessary to set up a new body to coordinate the work of supervisors. The Sub-Committee is composed of senior representatives of each Community central bank or another competent authority.

The principal task of the Sub-Committee is to hold regular consultations on matters of common interest relating to banking supervision. It pays particular attention to reaching a joint position among authorities on issues with a Community-wide dimension. Equal attention is being devoted to communicating positions where necessary. One such issue is the stability of both financial institutions and markets in the Community, and for that reason it often creates working groups to carry out detailed studies. In order to ensure effective coordination with other actors, it liaises with, for example, the Basle Committee, the EC Banking Advisory Committee and with the Commission of the European Communities.

Since its formation, it has dealt with following matters: the proposed European System of Central Banks (ESCB), supervision of financial conglomerates, consolidated banking supervision, the BCCI affair, and cooperation among European national credit registers.

Although being predominantly oriented toward monetary matters, the Sub-Committee also pays due regard to matters falling within the competence of the central banks and affecting the stability of financial institutions and markets. It has been realised that central banking and broad monetary affairs should not be dealt with separately from financial markets. A close cooperation between central authorities in this regard should add another perspective (macroeconomic) towards the role of financial markets. Furthermore, the composition of the Sub-Committee "upgrades" the macroeconomic perspective to the Community level. So, the basic value of order (stability) is not to be promoted only at the national level, but also at the organization's level.

#### c) The OECD Committee on International Investment

The Committee on International Investment and Multinational Enterprises was established by the OECD Council in 1975, in order to establish a framework

for close cooperation relating to cross-border transactions. Its first task was to draft a set of guidelines for conduct of transnational business, in consultation with two other OECD bodies: the Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC).

The Committee exemplifies a response of the intergovernmental world to emerging global markets, but very different in nature from other governmental responses. It resembles the Organization's perception that international flows of capital are mostly beneficial to recipient countries, and therefore liberalization of markets are a prerequisite for further economic growth.

"From the 1960s on, liberalisation gained impetus and has continued and developed to the present. These efforts have been part and parcel of a broader trend in the OECD area encompassing liberalisation of cross-border capital and service operations, greater recourse to the operation of *market forces, deregulation and privatisation*, fiscal reform, and so on. The generally more welcoming attitude to international direct investment is also related to the growing *internationalisation and interdependence* of economies..."<sup>252</sup> (italics added)

The Committee's scope of concern and approach are also different from other actors on the scene. Measures chosen to affect rising global markets are primarily oriented to financial institutions and firms. They are not so much regulatory and restrictive in nature, but seek to influence (guide) the behaviour of market participants. At the international level, these measures are aimed at strengthening and further developing mutual cooperation and understanding between governments and investors.

The work of the Committee has to be viewed within a broad approach taken by the OECD towards international investment. In 1961, the Member States adopted the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations. It was sought to abolish progressively all restrictions on movements of capital to the extent necessary for effective economic cooperation. That included granting authorization for direct investments, admission of securities to capital markets, buying and selling of securities, operations in real estate, personal capital movements, etc.<sup>253</sup> In 1976, the OECD adopted the Declaration on International Investment and Multinational Enterprises and the related instruments: the national treatment instrument, the Guidelines for Multinational Enterprises, international investment incentives and disincentives, and Conflicting Requirements. The Committee had a significant role in designing the Guidelines, and also participated in devising other instruments. The importance of these instruments, accompanied by the Codes, derives from the fact that they address

"... a complex set of economic social factors affecting international trade, balance of payments, finance, technology, competition and market structures, industrial patterns and employment."<sup>254</sup>

Moreover, they have been created to provide governments, politicians, the business

community, labour organizations and the public with guidance in dealing with cross-border transactions. The complexity of the transactions, as well as their overall impact on economic and social transactions were taken into account. The values of freedom and equality rank as the highest general priorities, but the Committee has allowed certain important exemptions. For example, under the National Treatment instrument, governments are permitted to assess its implementation from the aspect of "classical" national interests.

"The Member countries should, consistent with their need to maintain public order, to protect their essential security interests and to fulfil commitments relating to international peace and security, accord to enterprises treatment ... no less favourable than that accorded in like situations to domestic enterprises."<sup>255</sup>

However, as these grounds have been frequently used to justify the imposition of barriers, efforts have been undertaken to limit the use of such measures. In this context, the Council decided in 1991 to formulate the Committee's tasks more explicitly. Since then, its general tasks have been to follow the implementation of the instruments, and to propose measures for abolishing the exceptions (e.g. for the National Treatment). The Committee's special tasks have been formulated so as to improve its role as a forum for direct consultations, as well as to invite views of other Committees, the business community and other parties.

The Committee's prospective role in debates concerning the global securities market can be assessed from three perspectives. Firstly, as the OECD is represented in IOSCO, the Committee is well positioned to communicate the Organization's views to securities regulators worldwide. Secondly, it can exert influence on national regulators, both during negotiations and when implementing measures on the Organization's level. Thirdly, it is among a very few actors that address the business community itself, apart from the "sovereignty-bound actors". The set of adopted Guidelines, together with other internationally agreed codes of conduct, marks a (probable) shift in attitudes of the intergovernmental world toward the multi-centric world. The analysis of the Guidelines will be included in the following chapter.

#### d) The UN Commission on Transnational Corporations

The United Nations Commission on Transnational Corporations (UN CTC) was established by the ECOSOC in 1974, following the report of the Group of Eminent Persons.<sup>256</sup> The Commission was designed as an intergovernmental body, subsidiary to ECOSOC, consisting of experts from 48 countries. Its primary role was to act as a forum for discussion and comprehensive consideration of matters relating to transnational corporations. It features a characteristic that is assisted in a private consultative capacity by a number experienced professionals and academics. They all come from both industrialized and developing countries, so a

diversity of views and experience is maintained.

"The decision [to establish the Commission] acknowledged the need to establish a focal point for the deliberations already being conducted by the international community on transnational corporations. In addition, it recognized the importance of involving individuals from the quarters directly concerned and immediately affected by these deliberations."<sup>257</sup>

The UN Centre on TNCs was created with a mandate to assist in the formulation of international arrangements, agreements, and a code of conduct. It was also given the task of studying the political, legal, economic and social aspects of TNCs' activities, as well as developing a comprehensive information system on their activities. In 1977, it set up the Intergovernmental Working Group for formulating a code of conduct. It was not just a broad socio-economic perspective that distinguished the work of the Commission from other actors. The negotiating technique that its Group adopted has been quite innovative. As it was faced with diametrically opposed proposals from industrialized countries, on the one hand, and developing and socialist countries, on the other hand, the Group decided to take a step-by-step approach in compromising over matters of concern. The objective was to elaborate the language covering the concerns of governments and to reach, as much as possible, a consensus. However, by <sup>the</sup>mid-1993, the Code had still not been completed.

The negotiations over the Code, its content and legal nature, illustrate how deep disagreements exist between governments from industrialized and from developing countries. The first group wants to avoid all-encompassing, binding requirements. Their corporations should be free to operate and allowed to call on their home countries in cases of serious international problems. The second group of governments expects a binding code and TNCs to respect the interests of host countries. The corporations should refrain from interfering in internal affairs, and contribute to development objectives of host countries.

"In essence, the problem seems to turn upon the fine tuning between the autonomy of the entities and the demands of the global strategy of the transnational corporations as chartered at its headquarters. Ultimately, the issue is the redressing the economic imbalances between North and South."<sup>258</sup>

Although the Commission has not been directly involved in debates over the global securities market, its work on the Code could have a significant impact. Bearing in mind that most banks and securities houses, participating in the market, are indeed transnational corporations, the importance of the proposal should be acknowledged. In addition, as a number of its provisions have found consensus among all-group-of-countries, the Code can usefully complement any eventual framework (or regime) in the area.

"An international framework agreement which limits itself to the

intergovernmental level, by necessity omits considerations of a series of important and difficult issues... The actual conduct of enterprises is not touched upon in intergovernmental instruments such as that being negotiated in the field of trade in services."<sup>259</sup>

As this approach receives a wider support, the Commission is going to gain in importance as a political actor on the scene.

The list of international regulatory groups does not end here<sup>260</sup>, but the ones analyzed seem to illustrate, to an adequate extent, the diversity of intergovernmental efforts to deal with the rising issue.

To conclude this lengthy survey, the world of today features a great diversity and multiplicity of political actors. In this particular case, that diversity ranges from individual banks and local associations, through various international organizations and associations, to universal organizations such as the United Nations. The actors have been categorised (just for analytical purposes) into four groups: banks and dealers, international non-government organizations, national authorities and international organizations. In spite of that, strict demarcation lines between them have proved to be theoretically unjustifiable. Attitudes and postures of an actor cannot be *ex ante* defined, just according to its name, status or origin. The same applies for values one may expect they strive to enhance. It is not always the case that banks are solely interested in promoting freedom to operate, efficiency or the value of wealth. By the same token, government regulators may well consider the values of order and safety as subsidiary to over-all efficiency. However, a few very general conclusions can be drawn.

Firstly, the ranking of values which are to be promoted or preserved varies across actors and time. Although banks and their associations primarily accentuate values such as freedom and wealth, they indeed recognize that order must be maintained at all levels of functioning. National regulators and their "organizations" still predominantly stress the values of order and safety. Even so, they have come to accept the fact that the pursuit of these values is ineffective if it seriously hampers over-all market functioning and efficiency. So, both "sides" have entered the political process, bearing in mind that a compromise has to be reached at the intersection of their aspirations.

Secondly, there is a great diversity of actors, both within and among the groups. Two developments have to be underscored in this respect. Financial institutions of today have grown out of their "classical" intermediation functions. Banks have developed transnationally not just to be able to execute orders and underwrite securities worldwide - modern banks persistently (and successfully) endeavour to shape the environment by using the political system. On the other hand, regulators have realized that the maintenance of close contacts with the business community is necessary. Moreover, contacts must be established and nurtured also with professional associations in other countries, as well as with

international non-governmental organizations.

Thirdly, the multiplicity of channels through which an actor can contend over political questions emphasizes an unrecognized (but highly sophisticated) global network of communication and debate. In the case of the global securities market, this less visible side of the phenomenon certainly deserves much more theoretical attention if analysis is to be accurate. The frequency with which most of the actors communicate (internally and externally) adds to this global market a new adornment: very lively, round-the-globe and round-the-clock political interplay. As the market continuously advances, the issue ranks higher and higher on the political agenda. To recall Keohane and Nye<sup>261</sup>, this survey clearly illustrates an ongoing shift in the world political reality: from the realist ideal type toward complex interdependence. What is still missing for the whole picture of complex interdependence is an outline of agenda setting and concrete stakes that are under the contention. The following chapter elaborates this in more detail.

## **CHAPTER SEVEN: AGENDA FORMATION AND THE EVOLUTION OF GLOBAL NORMS**

So far the analysis has outlined different aspects the economic content of the global securities market. Firstly, its origins have been described from a wider historical aspect. Then, the market's roots have been examined with regard to the "classical" market functions, the main participants and their national "ingredients". Thirdly, the global market has been delineated according to its main segments and features, relying primarily on quantitative findings. Fourthly, four major financial market disturbances have been included in the analysis in order to underscore the significance of market warnings to both regulators and market participants. This analytical shift demanded new theoretical frameworks to be drawn in, and the study has turned to the field of International Relations.

Two subsequent chapters have offered an alternative course for a study of the global market over and beyond the economic data. The Globalist approach to international relations seems to be the only, theoretically justifiable and practically useful, paradigm able to comprehend modern world phenomena. The part of this analysis related to political actors has undoubtedly demonstrated that complexity of the global capital market does not entail only numerous instruments and techniques. In addition, that complexity is built upon different networks of communication, bargaining and negotiations among a great diversity of actors on the scene.

The most important actors involved in the global debate about securities markets have been described in the previous chapter. Their communication, a particular, global political process, has been centred around several political questions or stakes in relation to the global market. These stakes differ according to salience they invoke for different actors, they vary in relation the type and status of stake, but they also differ concerning the number and diversity of values involved. The level of stake generality also varies, as well as the nature of access routes for different actors. As this is a rather novel approach to analyzing the global market, specific theoretical grounds first have to be presented, followed by a careful application.

### **7.1. Agenda setting**

The concept of issues has been presented in the part of the analysis dealing

with four main perspectives on International Relations (Chapter Five, section two). Just to summarize<sup>262</sup>, an issue comprises a set of political stakes linked by the values they embody, while a policy contains a set of answers to a series of political questions which are handled simultaneously by political actors. Similarly, an issue-system presents a set of actors, a set of stakes (linked by the value) and a process of interaction among the actors about the stakes. When the actors contend over proposals for the simultaneous disposition of stakes from value-linked issues, there exists a wider issue-system. For example, a wider issue-system for maintaining stability of global economic flows includes the following issues: international v. national control, macroeconomic coordination v. competition, international lending (for balance-of-payments purposes), and money laundering. A wider issue-system for improving global economic efficiency consists of issues such as the market integrity, transfer of technology, trade v. direct investment, etc. These issues are perceived as being on the same issue-dimension, i.e. relevant for the realisation of values of order and security, in the first case, and relevant for the value of wealth in the second.

When it comes to dealing with issues and stakes, the real world of political behaviour may be more complicated, functional (and other) linkages create policy-systems. So, a wider policy-system encompasses functionally related policies, when the actors contend over proposals for simultaneous disposition of stakes from these policies.<sup>263</sup> For example, there is a wider policy-system for global capital flows, cutting across several wider issue-systems and including several policies such as integration of the European Community through Economic and Monetary Union, control of terrorists and drug barons through prevention of money laundering, international action against Saddam Hussein through financial sanctions, or promotion of development in newly industrialising countries through creation of new capital markets. In the case of policy-making for the global capital market the functional linkages alone dramatically increase the political complexity, even before bargaining linkages or actor linkages are considered.<sup>5</sup> Stakes, like for example entry requirements, data reporting, standardisation of market procedures, are interrelated to such an extent that their disposition must be negotiated within a broader context. This is has to be done simultaneously even though the stakes relate to different issues, and lie on the different issue-dimensions. Actors perceive certain stakes and issues (or groups of stakes and issues) as being related to certain values, whose satisfaction they aspire to maintain or increase. It is therefore necessary to examine how and why certain actors perceive issues as being relevant to them, how they attract the attention of decision-makers, and how and when issues reach the agenda.

"An agenda consists of proposals for allocating stakes in issues over which

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<sup>5</sup> I am grateful to dr Peter Willetts for making helpful suggestions on the nature of functional linkages.



actors are contending... A single global agenda can be identified and can be defined as those issues and associated proposals that attract serious attention from either a large number of actors or from those capable of resolving the claims."<sup>264</sup>

What the analysis has to identify, therefore, is parts of individual actors' agendas that overlap.

Different factors influence agenda setting, like feelings of deprivation, organizational context, actor communication and their status, etc. But before an issue reaches a stage when it has attracted "adequate" attention, claims of those deprived have to be specified and wider support has to be acquired. For example, the proposals for regulating investment banking in the EC had been discussed in various fora (e.g. the European Banking Federation, national investment banking associations, etc.). Nevertheless, as long as investment banks did not clearly articulate and specify their "discontent" with the proposals (e.g. minimum capital requirements, sectoral barriers, etc.), and until they did not attract sufficient support of high-status banking associations and international organizations, the issue of liberalization of international investment operations did not enter the formal agenda of the wider policy-system for global capital flows.

An even better example is the issue of market quality, particularly in relation to business conduct of transnational firms. This issue was initiated in mid-70s, including actors such as the International Labour Organization (ILO), the International Chamber of Commerce, OECD, UNCTAD and the UN Commission on Transnational Corporations.<sup>265</sup> It, however, remained dormant for some time, or precisely, until the late 1980s. Then, activities of other actors, like the International Federation of Stock Exchanges (FIBV) and the International Organization of Securities Commissions (IOSCO) brought it back to the agenda in a slightly different form<sup>266</sup>. The issue was re-defined and specified around a number of principles to guide business conduct (honesty, best efforts, cooperative attitude toward regulators, etc). These principles will be analyzed later in more detail. The rise of the issue's importance can be attributed to two factors: it has attracted "sufficient" attention of two high-status actors, and it has ranked high on the agendas of more than one hundred actors joined in the organizations (covering more than 70 countries world-wide). So, it has reached the final phase: entrance to a formal agenda.

Mansbach and Vasquez<sup>267</sup> have offered an agenda-setting model, with three main variables: issue-salience, access routes and the status of actors involved. Among them, salience is indisputably the most important variable, because it refers to the perceived importance of an issue to an actor. The extent to which an actor will feel an issue as being relevant to its objectives depends on few factors.

An issue will be more salient if it involves a value-deprivation, as opposed to an issue which pertains to an already satisfied value. For example, the issue of

liberalization is not felt as being so critical, because a certain level of openness (satisfaction of the value of freedom) has already been achieved. Contrary to that, the issue of international control is very salient to most actors: regulators feel deprived of order, and banks and market participants feel deprived of the value of security.

Another factor that influences issue-salience relates to the number and diversity of involved values. The greater the number and diversity of values underlying an issue, the higher its salience. The issue of liberalization involves different values, such as freedom, equality, wealth and security. Although belonging to the same wider issue-system (maintaining the global economy openness), the issue of economic integration does not rank so high on agendas, partly because it involves a smaller number and more homogeneous values (such as freedom and equality).

Issue-salience also depends on the status of the stakes under the contention. If the stakes are outside the control of any actor, they will not induce a high salience. But, if the stakes (that compose an issue) are already controlled by an actor, or a group of actors, the issue-salience will significantly increase because it will involve perceptions of the danger of value deprivation. For example, the stake of self-regulation (mode of control) has provoked vigorous debate over its advantages and shortcomings, between proponents of the "anxiety" approach (e.g. the US Securities and Exchange Commission) and proponents of the "confidence" approach to banking regulation (e.g. the UK Securities and Investment Board).<sup>268</sup>

The type of stakes which the actors contend over is the next factor influencing salience. If an issue includes concrete stakes, whose disposition will immediately and directly affect value satisfaction, it will be perceived as being less salient in comparison to an issue which revolves primarily around less concrete stakes. For example, the issue of market quality includes concrete stakes, such as standardisation of procedures, trading halts, trade reporting, etc. On the other hand, the issue of international control encompasses symbolic stakes, which just "allow" value deprivation or enhancement (e.g. capital adequacy) without an immediate impact. The issue of liberalization v. protectionism revolves around transcendent stakes (e.g. benefits from global integration) which are related to general beliefs and norms and should therefore invoke the highest salience.<sup>269</sup>

Once the issues have been perceived as salient for an actor, it can take different routes to bring them to the agenda. Some of these routes have already been exemplified in the analysis of particular actors in the wider policy-system of the global securities market. High-status actors (owing to their role /reputation /resources) usually take a direct route and can themselves place a salient issue on the agenda. For example, the Basle Committee on Banking Supervision has entered into direct communication with the other major actor in the system, IOSCO, to discuss various issues in relation to investment banking. Another high-status actor (e.g. the British Banking Association, BBA) has taken an alternative, though not less

influential, indirect route through international organizations: through IOSCO, the European Banking Federation, etc. Actors with a lower status have to rely on influencing high-status actors, or alternatively on an indirect access to international organizations (e.g. the British Merchant Banking Association, being a member of the BBA).

So, the process of agenda setting will depend upon the level of issue-salience, the variety of possible access routes for communication and influence, and the status of actors in the system. A wider policy-system for the global securities market handles numerous issues, with a varying degrees of salience for the different actors. It can be perceived as encompassing a number of functionally related policies, as it cuts across at least four wider issue-systems: efficiency, economic stability, political stability, openness and development. These wider-issue systems include several particular issue-systems, each comprising actors, stakes and processes between those actors. For example, the issue of liberalization belongs to a wider issue-system for maintaining global economic openness. Together with other issues (like regional v. global integration, integration v. autarchy, etc.), it is closely related to the value of freedom. Functionally, it is related to issue-systems such as the quality of the market, international v. national control, and the issue-system of emerging markets. So, the politics of the global securities market actually involves the contention over stakes belonging to different policy-systems, as well their simultaneous disposition. Nevertheless, global capital flows are not the only flows to transcend state borders and state jurisdictions. Transnational production, resource utilization, global trade and communication flows are all aspects of a truly world economy. Therefore, the global economy can be viewed as a policy-domain, and the choice between maintaining an orderly market economy, as opposed to a socialist command economy, as one among several hyper-issues the world faces today.<sup>270</sup>

One of the conclusions from the previous chapter is that different actors differently rank their priorities and goals, and hence the values they support have a different ranking. For example, banks and business tend to attach more importance to the values of freedom and wealth, than to security and order. On the contrary, most of the regulators and their organizations put forward the values of order and stability. The contention among these two positions (groups of actors) actually involves discussing the ranking of issues on the global agenda. Mansbach and Vasquez describe this as the relative salience of issues:

"It provides a way of comparing the concerns of individual actors and ranking them according to the significance that they have for global society as a whole. A major part of the agenda-building process is a struggle over salience rankings. The most important of these struggles is over which issue will be at the highest ranking, thereby taking precedence over all others."<sup>271</sup>

It however has to be kept in mind that contention over the relative position of issues

on the agenda primarily concerns high-status actors. During this process, a number of "most explosive issues" (Mansbach and Vasquez, p. 107) will come to dominate the agenda. This is particularly the case if the stability of the status hierarchy (Mansbach and Vasquez, p. 113) is challenged. For example, the issue of international v. national control of global operations is highly salient for different reasons. The hierarchy of actors, for a long time dominated by both US firms and regulators, has been undermined by the rise of actors and organizations related to Euromarkets. Secondly, the hierarchy of actors has been challenged by the expansion of international non-governmental actors in the field of finance. Regulators from countries other than the US, as well as international non-government organizations, have gained in power/control over both resources and outcomes. So, stakes like whether the self-regulatory or statutory concept should dominate international regulation of global financial flows, or to what extent national regulators should be compelled to cooperate and share information with other actors, can be regarded as the parts of this critical issue.

Agenda setting depends on issue-salience, access routes to the agenda, and the status of engaged actors. Nevertheless, not every issue can reach the agenda, and, even among those which get to be discussed, not all will be settled. Sometimes, issues are brought to the agenda, discussed and contended, with decisions being made in relation to them. Sometimes, however, issues do reach an agenda, but definitive arrangements for their resolution are not possible. Some issues never come to an agenda, and yet some issues on an agenda stay latent for some time before they are finally resolved or removed from the agenda. Mansbach and Vasquez analyze these shifts through the concept of issue-cycle.<sup>272</sup>

"During its life, an issue may be characterized by changes in stakes, fluctuations in perceptions regarding those stakes, and variation in the cast of actors that are contending for them... Critical issues usually pass through at least four, and sometimes five, stages once they have reached the global agenda: crisis, ritualization, dormancy, and/or decision making (as alternative paths off the agenda), and administration."<sup>273</sup>

Before analyzing these stages an additional theoretical remark has to be made, regarding various sources of issues. Mansbach and Vasquez have defined two basic origins of issues: the environment and the actors.<sup>274</sup> The first comprises factors that are not directly linked to the behaviour of actors, e.g. technological advances or the rise of common problems that endanger existing value satisfaction. For example, improvements in the computer and telecommunication technologies have greatly contributed to the emergence of new issues and stakes (e.g. international regulation of transborder data-flows), as well as to changes in the underlying values (e.g. the value of international security now encompasses, inter alia, economic security). Secondly, the actors can also be a source of issues when, as a result of their behaviour, new stakes are created or old ones brought to an agenda. For

example, the entry of large investment banks into Euromarkets have significantly altered the perceptions and policies of other market participants, national regulators and international organizations in this field. There is no need to elaborate this in more detail, because the first part of this analysis (Chapters 1 to 4) has actually described both sources of the issues related to global capital flows.

So, once a critical issue comes to an agenda, it passes through several phases. The duration of each of them depends on various factors, such as the existing structural arrangements, frequency of communication, issue-salience, etc. During a crisis phase, interactions become more frequent and actors come to realize that their expectations are not valid any more. A need for new arrangements emerges, which leads to the second stage: a ritualization phase. The involved actors still take hostile attitudes towards each other, but there will be signs of patterned behaviour and shared perceptions of rules and limits. From there, an issue can pass to an administrative stage, where final allocations will be made. More often, however, actors will make some interim decisions, before certain conditions for a final disposition are met. Alternatively, an issue can pass to dormancy (with or without any interim decision) and remain latent for some time, before it is brought back to the agenda or definitely removed from it. For example, the BCCI affair and its aftermath (Chapter Four) can now be reviewed from another perspective. The issue of international regulation has become a critical one. National regulators have realized that new arrangements are urgent. Transnational banks' expectations about the continuous, adequate functioning of "free" market forces have become groundless. Frequency of interactions and communication among major actors has dramatically increased, resulting in a consensus over the nature of the problem: more order on the global financial market has been perceived as the key objective. Nevertheless, actors have still not managed to reach an agreement over a set of policy tasks and norms to handle the issue of international regulation. So, it can be concluded that the issue is still in the ritualization stage.

A number of the other issues related to global capital flows have also entered the global agenda: some of them are still in the crisis stage, and some have been moved forward in the issue cycle. As it is very difficult to draw (ex ante) a strict distinguishing line between the two stages for each particular issue, the analysis will now focus on concrete (actual) stakes under contention.

## **7.2. The global agenda**

As described, a global agenda consists of parts of individual actors' agendas that overlap, i.e. it comprises issues which are seen as having high relative salience for most of the high-status actors. Global capital flows, similarly to other

phenomena of the modern world, have induced a great variety of stakes that have come under contention. Out of them, only few have attracted "adequate" attention of actors that are capable of making an authoritative allocation of values.

### 7.2.1. International control and co-operation

An extraordinary expansion of global capital flows has left most regulators faced with various dilemmæ: how to assess and compare economic benefits from this integration; how to approach, organize and carry out control over these activities; whether to control institutions or financial activities; how to "grasp" the complexity of the global market; whether to co-operate with other regulators (national authorities), and "give up" a certain degree of autonomy, or to pursue an "independent" national policy... Since the end of the 1980s, and particularly after the BCCI episode, a wide consensus has been reached upon the fact that global economic integration must be accompanied by closer co-operation (and even collaboration) among regulatory authorities. The work of the Basle Committee on Banking Supervision, as well as some directives adopted in the EC, establishes that a general agreement has been concluded about the basic nature of the problem. There remain, however, some significant questions which are still open: the mode of control (statutory or self-regulation), supervision of financial conglomerates, the nature and the extent of cooperation among regulators, and, above all, capital rules for securities firms.

One of the pillars of the international supervision of banks, which would later serve the framework for securities houses as well, is the 1975 Basle Concordat. It was revised in 1983, and supplemented in 1990. The Concordat outlined principles for the supervision of banks' foreign establishments on a consolidated basis<sup>275</sup>, so that it is possible to supervise the financial side of the group as a whole. Consolidated supervision was accepted as a regulatory response to an ever-growing internationalisation of banks. The Concordat allowed for the allocation of regulatory responsibilities between the host and the home country. Both countries are responsible for the supervision of the group: the home country assesses the group's solvency and liquidity, while the host country monitors these parameters for the foreign banks' establishment on its territory. If either of the two sides fails to carry out its duties properly (or if one side perceives the other as being incapable of doing that), the other can turn to alternative arrangements. The home country could (should) extend <sup>its</sup> their supervision extraterritorially, or discourage the expansion in the territory concerned. The host country could discourage or prohibit establishment on its territory, if it regards supervision by the bank's home country inadequate.

"Adequate supervision of banks' foreign establishments calls not only for an appropriate allocation of responsibilities between parent and host supervisory authorities, but also for contact and co-operation between them."<sup>276</sup>

The basic principles of the Concordat, i.e. that no foreign banking establishment should escape supervision, and that the supervision should be adequate, were extended and supplemented in 1990. Regulators were encouraged to develop more regular and structured collaboration among themselves, in order to improve the quality and completeness of the supervision. Host and home authorities should fully cooperate during the authorization procedure, and information needs of both sides should be met as completely as possible. For example, the parent supervisor should ensure an adequate flow of information from the parent bank in a consolidated form, on the basis of regular reporting within the group. Mutual trust should be developed between the home and the host supervisor, including a continuous flow of information, removal of secrecy constraints, maintaining the confidentiality of information, etc.<sup>277</sup>

In the summer of 1992, the Committee produced a new paper, setting out minimum standards for the supervision of international banking groups and their foreign establishments.<sup>278</sup> The BCCI affair had crucially influenced these recommendations, which should be applied by individual authorities in their assessment of the relations with corresponding regulators abroad. One of the most important standards is related to a request, made to the host country authority, to evaluate the home country capabilities to perform consolidated supervision. This includes reviewing the home authority's powers, experience and practices. So, all international banks should be supervised by a "capable" home country authority, which is the first one to give its consent to the bank's outward expansion. This consent should be made contingent upon the subsequent inward consent of the host country authority. In order to supervise the bank adequately, the authorities should possess the right to gather information about the bank's foreign establishments. Finally, if the host country were to perceive one of the standards as not being met, it could impose restrictive measures and even prohibit entry. From a broad policy perspective

"... the major thrust of the minimum standards paper was aimed at 1) strengthening the application of the principle of consolidated supervision to all internationally active banking groups, 2) adding a further element of discipline to practices surrounding the cross-border establishment and maintenance of banking offices, and 3) promoting a still higher level of communication and coordination among the international community of bank supervisors."<sup>279</sup>

The underlying principle of home country control was also included in the 1989 EC Second Banking Coordination Directive.<sup>280</sup> It was accompanied by the principle of mutual recognition by the EC supervisors of each other's measures and

practices (e.g. authorization and prudential supervision systems). So, branches of banks, in whichever EC member state they are located, are supervised by the home country authority. In order to avoid a particular "regulatory competition" (by authorities) and excessive "regulatory arbitrage" (by banks), it was necessary to intensify harmonisation of bank regulation within the EC.<sup>281</sup> In 1990, an amended proposal for a Council directive on investment services was made<sup>282</sup>, reiterating the principles of home country supervision and mutual recognition. The responsibility for supervising the financial soundness of an investment firm will rest with the home-country authority. Once authorized, an investment firm can establish branches or provide services throughout the Community. At the time of writing the Investment Service Directive has not been accepted, but a political agreement has been reached on contentious elements - publicity of securities transactions, and the direct access of banks to stock markets. However, there are still several stakes which are under the contention, but they are relevant for the proposed capital rules and for the issue of liberalization v. protectionism.

So, even the principle of consolidated supervision of banks and securities houses is not under the contention. Its importance for a prospective regime for global securities flows is immense. Furthermore, one of the main organizations in the field of securities business regulation - IOSCO - has issued a list of principles which should serve as a basis for establishing proper contacts among regulators.<sup>283</sup> Practical questions involved in the negotiation and implementation of a "Memorandum of Understanding" (MOU) are: investigatory assistance as broad as permitted, confidentiality, a clear description of procedures, protection of the rights of persons subject to an MOU request, consultation of the authorities, public policy exceptions, types of assistance, uses of information, participation of authorities and the cost-sharing.<sup>284</sup> So, authorities should cooperate to the fullest extent, but on a reciprocal basis and always within the limits of national laws and public policy.

"An MOU should provide that the Requested Authority maintains the right to refuse to provide assistance in instances where the provision of assistance would violate the public policy of its state. The concept of public policy would include issues affecting sovereignty, national security, or other essential interests."<sup>285</sup>

This "public policy exception" can be found in most of the directives, declarations and codes concerning global capital flows. If such an escape clause is maintained, it is evident that no kind of a supranational regulator can be created, and that any kind of future arrangements will have to rely on voluntary cooperation of authorities. Time will show to what extent regulators are really in favour of a close international cooperation in market oversight and regulation.

Nevertheless, what still remains under contention is the question of self-regulation, as opposed to statutory regulation. Self-regulation has long been practised in the countries that take the "confidence" approach to banking and



investment business (e.g the UK). In the securities industry, it involves participation of securities exchanges and associations of securities dealers in the regulation process. One of the primary reasons for self-regulation is that such organizations are "closer" to the market and hence more aware of the problems, structures, participants' attitudes, etc. The International Federation of Stock Exchanges (FIBV) is among the most prominent advocates of this concept, and has recently completed a report on self-regulatory rules and standards.<sup>286</sup> Self-regulation has many advantages over the statutory (government) regulation, such as an ability to improve ethical standards, participation of practitioners, sensitivity and responsiveness to meet changing needs and developments, an expertise in financial matters, lower costs, etc. Therefore, self-regulation should cover various areas of securities business, like securities listings, market surveillance, clearance and settlement, licensing, codes of business conduct, arbitration, insider-trading detection, etc.<sup>287</sup>

A recent FIBV report<sup>288</sup> has revealed that a wide basis for national and international self-regulation already exists. Moreover, there is a significant degree of readiness of the institutions concerned to share information and cooperate in this course.

"The Report concluded that most (97 percent) FIBV member exchanges have significant market surveillance and investigative capabilities, which can produce comprehensive reconstructions of trading in their markets. The Report observed that 37 percent of the exchanges indicated that they could disclose customer information to securities markets outside their home country."<sup>289</sup>

So, the potential and the willingness are already there and it is now up to international government organizations to make the best use of that.

The "anxiety" approach to banking and finance calls for a different exercise of control and regulation, either directly by the government or through official regulatory agencies. Proponents of statutory regulation put forward various arguments: 1) self-regulatory organizations cannot properly distinguish between the interests of the public at large and the interests of their members, 2) self-regulation can create a "captured regulated system" (a cartel which operates in the interests of established major firms within the regulated industry)<sup>290</sup>, 3) the securities industry is a business that affects public welfare, and therefore requires public supervision and control, 4) self-regulation, without government supervision, may provide only the appearance of protection for the public, and 5) self-regulation is based on limited or even inadequate standards, application of which is "left to the unfettered discretion of private regulators"<sup>291</sup>.

"The anti self regulators cry out such labels as 'industry capture', 'the rabbits can't tend lettuces' or 'poachers can't turn game keepers'. From the other side come equal insults. Statutory regulation is 'blind bureaucracy'; 'it pulls up everything green just in case its a weed'; 'armies of form fillers,'

'lawyers' paradise'.<sup>292</sup>

The self-regulation stake can be thought of as a symbolic one, disposition of which is primarily affected by changing hierarchy structures. It adds another dimension to the already critical issue of international control. Even though it has been widely acknowledged that regulators should fully cooperate, it is still a matter of dispute which (or what type) of regulators are concerned. In 1992, the IOSCO Consultative Committee has offered a "compromise" between these two: cooperative self-regulation. The self-regulators should bring regulatory problems, in their early stage, to the supervising governmental body in order to seek assistance in finding solutions. Government, in turn, should be open to proposals which it perceives as coinciding with public and general economic interests. It should also accept the self-regulators' private interests and their competitive needs.<sup>293</sup>

Another important aspect of international securities regulation concerns the nature and characteristics of the regulation itself. This has not yet been brought to the global agenda, but as the debate on various stakes goes further, and as some concrete decisions are made, the consistency and general orientation of the regulation will come into focus.

In 1992, FIBV issued a list of evaluation criteria for international securities regulation.<sup>294</sup> Recognizing the need for regulation of market forces and competition, the following criteria should be taken into consideration when designing (or evaluating) any international regulatory framework. The regulation should be market driven, flexible and responsive to market needs, and should minimally restrict free-market forces. It should aim at investor's protection and the maintenance of fair and orderly markets. The framework should generally promote competition, efficiency and quality of markets, but should also assure that transactions are conducted in a fair and professional manner. The ultimate goal of international regulation should be a reduction of the systemic risk inherent to the global market system. Finally, the regulation and control should be carried out, as much as possible, through self-regulation. So, even though certain interim dispositions have already been made through statutory regulation (e.g. capital rules), the general orientation of international regulation has not yet come under contention. This does not mean it is not salient to the actors, nor that there is a general consensus over the nature of regulation. It simply means that the regulatory elements have not yet been viewed as parts of the complex whole, so their complementarity and consistency still waits to be assessed. One of the criteria will definitely attract the attention of other actors: that the regulation should be market driven and lay a minimum burden on market forces. This will undoubtedly cause much contention, both among regulators and within the business community, particularly when it comes to assessing the "market-driven" ground for capital and disclosure requirements, entry barriers, etc.

"It is hardly surprising that the [US] SEC and the [UK] SIB find it difficult

to reach common ground: they are trying to achieve widely different goals. The SEC regulates for the worst case,... worst days and the most aggressive trading firms. By contrast, the British approach is to let securities firms do as much business as possible without taking huge risks which will disrupt the market."<sup>295</sup>

So, the issue of international control involves various stakes related to allocation of responsibilities and mode of control. It also tackles the stake of "supervisory imperialism"<sup>296</sup>, i.e. the debate over what kind of approach to international regulation should be taken: the one of banking regulators or securities regulators. In commenting on the proposed regulation of financial conglomerates, an EC representative to the 1992 IOSCO Conference pointed out that

"... the rules devised for regulating financial conglomerates should, so far as possible, respect the peculiar characteristics of the different sub-sectors and the legitimate differences in the way they have traditionally been regulated."<sup>297</sup>

It has been widely agreed that there would be a tremendous benefit, in the long run, from harmonisation of rules across the banking industry. The same applies to harmonisation of rules concerning the securities industry. Nevertheless, the situation is very different with respect to regulatory harmonisation between the two sectors, due to different regulatory priorities. Bank regulators aim at protecting depositors, controlling the influence of banking business (e.g. lending to industry) on the macroeconomic parameters (e.g. money supply), and preventing bank collapse. Securities regulators have different priorities, such as protecting investors from fraud and malpractice, promoting competition, the pricing of financial services, etc. Their approach is also different in relation to practical regulatory solutions. For example, most bank regulators favour the so-called "building-block approach" for market risk requirements, whereas most securities regulators apply the so-called "comprehensive approach". The first splits out specific risk requirements from those for general market risk, while the second captures both specific and general market risk in a single weight (this will be elaborated in more details in the following subsection).

The debate over which approach should be taken has been further fuelled by the traditional differences between the UK and continental Europe. The latter tradition includes universal banks as the leading model for financial institutions, so the countries like Germany, France and Switzerland have persistently lobbied for the bank-regulation approach. Many of the EC Directives in relation to the securities industry were modelled after banking regulation (particularly the German example), in spite of the fact that nature of the business is far from being the same. The aim was that banks should have a level playing field with securities firms, so that the competitive position of large universal banks would not be threatened. A comment made by a US investment banker on the intra-EC negotiations is particularly

illustrative:

"The people in Brussels have been comprehensively bullied by the Germans. I recently heard one senior EC official make the extraordinary statement that we have to have a German-style regulatory system, because they do not have financial scandals in Germany."<sup>298</sup>

So, bank supervisors (the universal banking lobby) have "hijacked" the EC negotiations on international securities regulation. However, this has not been the only "route" to the global agenda taken by the lobby. The US Securities and Exchange Commission, as the single most influential force among the securities regulators, has been taking a position quite similar to the one of continental negotiators: strict and tough capital rules, the comprehensive approach to risk requirements, a mistrust in portfolio and diversification theories<sup>299</sup>, etc. Nevertheless, at the beginning of 1992, a sort of a compromise has been reached among the two groups of regulators concerning a prospective agreement between them. Regulation of the two industries (banking and securities) would have basic elements in common, but allowing for important exceptions. For example, national authorities which already apply methodologies or techniques different from those agreed upon would be allowed to continue so - under the condition that they provide at least similar level of capital soundness.<sup>300</sup>

### **7.2.2. Capital rules**

These different approaches to international securities regulation were the grounds upon which some of the most fierce debates have emerged, particularly in relation to the instrument (object) of control - capital soundness of firms. Capital adequacy has always been at the centre of banking supervision, due to an unquestionable and long-held assumption that proper capital backing significantly reduces the possibility of a bank's collapse and serious market disturbances. Capital adequacy has most often been measured as the ratio of a bank's capital to its commitments (both balance sheet and off-balance sheet). Until recently, a great variation in the practical solutions (e.g. in the definition of capital) had existed, threatening the relative competitive standing of banks in different countries. In spite of an immense expansion of transnational banking activities, regulation had not "followed the suit" and had remain largely at the discretion of national authorities.

An important step towards the international convergence of capital regulation was the Anglo-American accord on capital adequacy measurement, in January 1987, as one of the policy responses managing the debt crisis. The importance of the accord lies in the fact that it was the most obvious illustration of the degree to which management of global economic phenomena has become a part of "high politics".

Actually, when the eighth largest bank in the US, "Continental Illinois", reached the brink of bankruptcy in 1984, American regulators finally accepted that a more comprehensive framework for capital adequacy was needed. As the Federal Reserve Board had already been for some time in close contacts with the Bank of England, the two sides found it particularly useful to act jointly. The Federal Reserve sought to achieve a two-fold objective: to force other countries' banks (particularly the Japanese ones) to strengthen their capital base, and to avoid any disruption in relations with the US domestic banking community. The Bank of England wanted to get a powerful ally in fighting against German-influenced efforts in the EC to impose alternative capital-adequacy standards.

"For the British, a joint US-UK approach would provide a powerful counter to the capital adequacy standard which was being debated in the Brussels headquarters of the European Commission and which the Bank of England found objectionable. For the Americans, a bilateral agreement would satisfy the US commercial banks, which opposed any new unilateral regulations that might place them at a competitive disadvantage."<sup>301</sup>

The 1987 accord provided a common definition of capital, adoption of a risk-asset system, the inclusion of all off-sheet commitments, and the calculation of specific capital/asset ratios for individual banks.<sup>302</sup> Many objections were raised to the accord, particularly by the Germans, the Japanese Government and by the American Bankers Association. They were primarily related to the need for a flexible regulatory approach (e.g. considering different traditions), dangers of overcapitalization, and equality of treatment, both between the US and foreign banks and between the US commercial banks and other financial service providers (e.g. securities houses). One of the problems associated with the Accord, which later provided a basis for hot debate over securities regulation, was the different perceptions of "adequate capital". The US regulators had used a simple, fixed, capital-to-assets ratio, regardless of the quality of the assets. In contrast, Britain and other countries had developed more sophisticated "risk-weighted" standards, and had paid "due attention" to other techniques used by banks to lower their risks (e.g. asset diversification). Although the accord was designed closely in line with the second approach, the attitudes of the US regulators were difficult to modify. What was important to them were "big numbers", i.e. the overall amount of the capital, and this later proved to be a serious obstacle for negotiating standards for securities firms. However, the accord did eventually provide a basis for creating a multilateral framework for regulating bank capital, as the most powerful weapon to strengthen the market.

The most important proposal in this field was made by the Basle Committee on Banking Supervision in 1988, known as the Capital Accord. It sought to achieve the dual objective of improving the soundness and stability of the international banking system, while at the same time being fair and consistent with existing

national regulation.<sup>303</sup>

"Two fundamental objectives lie in the heart of the Committee's work on regulatory convergence. These are, firstly, that the new framework should serve to strengthen the *soundness* and *stability* of the international banking system; and secondly that the framework should be *fair* and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of *competitive inequality* among international banks."<sup>304</sup> (italics added)

Following discussions in the Committee and public consultations, the capital agreement was revised in November 1991 to ensure greater consistency in defining bank capital.<sup>305</sup>

The basic elements of the Basle framework include the definition of constituents of capital, risk weights and the target, standard ratio. Capital is defined as consisting of two tiers: core capital (tier 1) comprises equity capital and disclosed reserves, while supplementary capital (tier 2) includes undisclosed reserves, revaluation reserves, hybrid debt capital instruments and subordinated term debt.<sup>306</sup> Each item of a bank's exposure is weighted according to a presupposed relative risk of counterpart failure (credit risk). Risk weights rank from 0 percent (applied to, for example, claims on OECD central governments) to 100 percent (claims on the private sector). A target standard ratio, to be reached at the end of 1992, was set up at 8 percent: it requires banks to hold \$8 of capital for every \$100 of lending. Regardless of on-going debates about the primary objective or the usefulness of the Accord, banks have boosted their capital ratios since its adoption. Some of the biggest US commercial banks have their capital ratio elevated to over 10 percent, while the German banks have gone even higher. French and Japanese banks were not so eager but most of them have already exceeded the 8 percent level.<sup>307</sup> A more detailed survey of the rise in banks' capital will be presented in Chapter Eight.

The approach taken by the EC is very similar, and has been developed in some directives related to banking and finance. The Second Banking Directive (89/646/EEC) establishes a minimum capital requirement, generally 5 million ECUs, for newly authorized institutions. Once authorized, all institutions have to maintain the capital at or above the level required. A significant inconsistency of the Directive relates to the definition of capital. At the time of authorization, it is core capital that must meet the requirements. Afterwards, any capital ("own funds"<sup>308</sup>) qualifying for the solvency calculation can count. In 1989, the Council adopted the Solvency Ratio Directive (89/647/EEC) which defines the method of calculating a solvency ratio for banks and prescribes a minimum ratio of 8 percent.<sup>309</sup> Most importantly, it gives the Basle agreement legal force in the Community.

Although these efforts, both in Basle and within the EC, definitely contribute to the enhancement of order in the global financial market, they fail to grasp reality

properly. Recent trends in modern finance, elaborated in Chapter Two and Three, underscore despecialization and disintermediation as basic features of the global market. So, there are many types of financial institutions operating today, there are numerous and various risks apart from credit risk, there are different techniques for controlling and hedging those risks, etc. At the beginning of the 1990s, the frameworks described seemed unsatisfactory for at least two reasons: they failed to include various market risks in assessing an institution's capital adequacy, and they did not provide adequate basis for framing similar standards for other financial institutions. The 1987 stock market crash focused attention on the growing interdependence of the world's securities markets and on the need to improve their regulatory structures.

The main forum for dealing with these questions became the Technical Committee of IOSCO. At the 14th IOSCO Annual Conference in 1989, the Committee presented a report on "Capital Adequacy Standards for Securities Firms". It was the first time that a common framework for regulating securities markets was proposed. Although it was not as detailed as the Capital Accord, it did refer to basic regulatory principles.<sup>310</sup> A securities firm should have sufficient liquid assets to meet its obligations, given the risks it faces. Marketable securities and commodities positions should be "marked to market", in order to give a true picture of a firm's positions. The requirements should cover all the risks, and in particular general management risk, position risk and settlement risk, within the so-called "haircut" approach (the ratio of equity capital rises with the riskiness of the assets held).<sup>311</sup>

As mentioned, the IOSCO Committee reached an agreement with the Basle Committee in January 1992, in relation to important aspects of the regulation of the securities markets. Proposed minimum capital rules would represent minimum standards, and would apply to internationally-active banks and securities firms, as determined by their national authorities. The rules would cover definition of capital and the methodology for assessing position risk for debt and equity. Concerning the first, it has been agreed that, due to the specific nature of investment banking, securities firms should be allowed to use short-term subordinated debt for capital. This, however, can only be done under certain conditions: such assets cannot exceed 250 percent of the firm's equity capital including reserves, and there should be a "lock-in" provision which prohibits the withdrawal of capital in the case of the firm's financial difficulties. In deciding whether to impose an "inner limit" on subordinated loans received from other entities (within or outside the group), a conflict among different traditions in banking regulation emerged again. On one hand, countries like Germany, France and Switzerland supported such a restriction: they feared that their universal banks would then lose the competitive advantage of having "big" balance sheets, in comparison to investment banks which have to rely on external loans. Most of the other countries on the Committee opposed the

inner limit.

In establishing a proposed standard for holdings of traded securities, the "building-block approach" was adopted (though with certain reservations made by the US, which were mentioned earlier). General market risk relates to a firm's exposure to broad market movements, while specific market risk concerns a firm's exposure to adverse movements in specific stocks. So, for each instrument two capital requirements are needed, and the sum of them presents the overall capital requirement. Concerning equity position risk, it was agreed that a minimum standard for a diversified book of highly liquid securities should be 4 percent of capital for specific risk and 8 percent for general market risk.<sup>312</sup> Apart from other questions under dispute, the SEC persistently opposed matching of the long and short positions of the firm (the so-called netting), while other countries accepted it to a certain degree.

In contrast to the IOSCO/Basle general (or broad) framework, the EC has developed a detailed and comprehensive framework for assessing capital adequacy of both investment firms and credit institutions. The proposal for a Council Directive on the Capital Adequacy (CAD), published in 1990<sup>313</sup>, included the following elements: 1) minimum capital requirements according to the type of business (e.g. ECU 500 000 for those directly engaged in trading, ECU 100 000 for agents or portfolio managers, ECU 50000 for others); 2) position risk requirements on securities holdings with certain "haircuts" (e.g. 10 percent for listed equities and 25 percent for unlisted ones); 3) a foreign exchange risk requirement of 8 percent, and 4) base requirements for investment firms (25 percent of a firm's overhead costs in the preceding year). In contrast to the IOSCO/Basle approach, netting between short and long positions is allowed, and debt instruments are categorized by maturity and issuer (central government, other public sector, qualifying and other)<sup>314</sup>.

The 1990 proposal on CAD has provoked strong debates concerning: investment firms' capital, the measurement of the risk, and the definition of capital to be provided against such requirements. Disputes have also arisen in relation to general treatment of investment banks in comparison to credit institutions (insufficient degree of harmonization), and treatment of some investment banking business (e.g. underwriting) not explicitly covered by the 1990 Proposal. So, in 1992, the Commission submitted an amended proposal for a Council Directive on capital adequacy<sup>315</sup>. The changes from the original proposal included, inter alia, those of technical nature and "amendments made to achieve more equality in the treatment of credit institutions and investment firms"<sup>316</sup>. The "building-block approach" for market risk has been adopted, separating general and specific market risk for both bonds and equities. For the latter, it demands 8 percent against general risk and 4 percent against specific risk. Concerning bonds, three basic classes of debt are envisaged: central governments items, qualifying items and other items, and specific risk weighting is attached to each of them<sup>317</sup>. For general risk, the CAD



procedure allows either a "maturity" approach or a "duration-based" approach. The first provides for offsetting of matched (i.e. long and short) positions across the maturity spectrum, which is divided into three zones. The firm's general capital requirement is then calculated according to a rather complicated formula, taking into the account all maturity zones, matched and unmatched positions. A modified "duration" basis takes account of a bond's current market value and remaining maturity: duration is the weighted average maturity of all payments of a security, coupons plus principal, where the weights are the discounted present values of the payments.<sup>318</sup> Another important change was introduced, regarding the treatment of underwriting. Firms are allowed a "discount" on the underwriting positions between 90 percent (working day one) and 25 percent (working day five). After the fifth working day, there is no reduction in relation to the underwriting positions.

Since the publication of the proposed EC Directive, an intense political debate has been carried out, including almost all actors portrayed in the previous chapter. This is definitely among the most critical stakes on the global agenda, since it has led so many different actors, from different countries and from different banking traditions to become involved. It is also a symbolic stake perceived to be related to a number of values which the actors seek to promote or protect. It has also contributed to redefining other issues (stakes), such as the issue of liberalization, the issue of market quality, etc.

For example, the UK banks perceive the CAD as a "tacit" agreement to drive large investment business out of London, probably to markets which have more lax domestic regulation, so that global competition structures will be affected. The capital adequacy stake has defined the axes of major coalitions, for example, between continental negotiators in the EC, the universal banking lobby in the EC, transnational commercial banks and large investment banks, and the US SEC, *versus* the UK regulators and smaller investment and merchant banks. The level of its criticalness can be assessed by analyzing how it cross-cuts prior alignments: the Bank of England and the Federal Reserve Board did act together in 1987 to impose internationally agreed capital standards, but the UK Securities and Investment Board and the US Securities and Investment Commission are certainly not allies in relation to capital rules for securities firms. There seem to be various linkages created between this and some other stakes and issues, the most obvious of which link the issue of liberalization ("passport for investment banks"<sup>319</sup>) and the issue of international control.

"The CAD is politically inspired. It is the Bundesbank's price for supporting the investment service directive (ISD), with which the British are keen to press ahead. Sir Leon Brittan, prime British mover behind the ISD, describes the CAD as 'the key that will unlock the ISD'."<sup>320</sup>

The German and French governments have taken the position that if investment business is to be liberalized throughout the EC, investment firms must be subject to

the same rules as the other players in the securities field, i.e. as universal banks.

The UK banks, as well as the UK authorities, fear that such regulation would severely affect the competition between large and small banks, but will also prevent securities firms from underwriting large Eurobond issues. Furthermore, underwriters would be forced to engage in the so-called "fire sales", as they have to provide the full capital backing for the positions held after the fifth day. The quality of the market will also be affected, as the new rules will considerably restrict market-making in equities (i.e. the risk they can take). The methodology for assessing equity positions is also under contention: British banks and authorities argue that it is too "crude" and simplistic, and that it does not include the quality of the issuer or the liquidity of the market for the security. The definition of a trading book is highly disputable, because it leaves all other-than-positions activities to be regulated as "banking business". Securities firms fear that if substantial amounts (8 percent) of core capital are tied up against the so-called banking activities (in their case, that would include fees due and foreign exchange risk), their capacity for trading will be further impaired.

Nevertheless, in spite of many "hot" political questions to be resolved, the process has advanced much further in comparison to other issues or stakes. It seems that the issue of international regulation and control has passed from the crisis stage to the ritualization stage, with the situation being that the nature of the goals has been agreed upon: it is the value of order that should be protected.

### **7.2.3. Liberalization**

Defining and maintaining a proper balance between restriction and promotion of market forces has always been one of the most important problems governments face. In the post-war period, regulation of the financial sector used to take the form of restricting market forces, i.e. curbing competition. Not only were cross-border capital flows and the right of establishment significantly restricted, but there was also direct intervention in the price mechanism (for example, interest rates were controlled).

From the 1960s onwards, government regulation has shifted from the restricted to more market-oriented systems. Interest-rate controls were gradually abandoned, capital flows liberalized and the financial sector progressively deregulated. Liberalization of cross-border activities has not been related just to capital flows, but has also been set as an ultimate goal for managing international trade (particularly under the auspices of the General Agreement on Tariffs and Trade, GATT). As global economic integration advanced, governments realized what had been accepted by business community long before: within the framework

of a market economy, pursuit of the basic value of wealth (efficiency) is crucially dependent on the protection of the value of freedom (openness). Until the end of 1970s, there was more a declarative inclination to openness and liberalization. This was true in both the OECD area and the EC. In 1961, the OECD adopted the "Code of Liberalisation of Capital Movements" and the "Code of Liberalization of Current Invisibles", while the Treaty of Rome (1957) explicitly calls for a gradual abolition of internal frontiers for the free movement of goods, persons, services and capital. The latter also implicitly includes the right of establishment and the progressive liberalization of banking and insurance services, as integral parts of the planned internal market.

While liberalisation momentum has built up and spread, the end of the 1980s saw a number of signs in policies and practices counter to this trend. For example, the US 1988 Omnibus Trade and Competitiveness Act contains some restrictive provisions in relations to foreign acquisitions: the President's new authority enables him to block individual foreign investments for national security reasons. There are also problems related to the imposition of conflicting requirements on multinational firms, e.g. when a home country's legislation with extraterritorial reach conflict with a host country's legislation or policies. The UK government has even passed a Protection of Trading Interests Act to give itself general authority to counter the problem of extraterritoriality. Recent years have also witnessed a growing use of reciprocity in the treatment of foreign investments by host countries, particularly in areas such as banking, insurance and other services. Concerns have also arisen in relation to the contribution of regional or bilateral agreements (NAFTA, Australia and New Zealand) to the development of a truly global economy. Restrictions on the range of activities in the financial sector (e.g. separation of banking and securities business) still exist, notably in the US and Japan. In many cases, regulators require establishment as a condition for permitting the offering of financial services, thereby excluding non-resident providers. Most of these restrictions are related to underwriting, broker/dealer services and syndication. Concerns have also been expressed, on part of the developing countries, in relation to the contribution liberalization can make to the development process, and also in relation to the integration of their emerging markets into the global financial market.

So, in short, the issue of liberalization of financial services has reached the agenda of most actors on the scene. Concerning governments of developed market economies, it can be concluded that the nature of the goals to be pursued has been agreed upon: in order to improve the overall efficiency of capital allocation, the global system must be kept as open as is feasible. The banking community also agrees that the global financial system should be maintained open, but they perceive the value of freedom as the prime motive for that. Freedom to move across state boundaries, freedom of investing and creating branches, freedom of operating and competing - these are all expressions of the same basic value. These perception are

also closely related to the protection of the value of equality, for example, equality between different financial institutions and between local and foreign institutions.

On the other hand, many developing countries still hold strong reservations about these values and put much more emphasis on the value of development. Actually, many developing countries perceive the value of freedom as the possibility of making their own "choices" regarding autonomous development policies. They may also agree, at least in principle, that the higher the level of the international system's openness, the greater the economic benefits. However, they are not able to accept the developed countries' package of norms in realizing this basic principle. Surprisingly, developing countries' perceptions in this regard sometimes resemble the ones of banking community: liberalization cannot be pursued without the value of equality (e.g. the access of their companies to developed countries' capital markets, or sharing of information). In order to comprehend the complexity of the issue, three approaches will be analyzed here - those taken by the OECD, GATT, and the EC.

The origins of the approach taken to the liberalization issue by the OECD can be traced back to its foundation. Pursuant to the 1960 Paris Convention, the Organization shall promote policies designed to achieve, inter alia, the highest sustainable economic growth and financial stability, and thus to contribute to the development of the world economy. From the beginning, it has set a goal of maintaining an open international (world) economic system, while improving the climate for international direct investment. As mentioned, two Codes were adopted in 1961, in order to set a general framework for a progressive liberalization of capital movements:

"Members shall progressively abolish between one another restrictions on movements of capital to the extent necessary for effective economic cooperation... Members shall, in particular, endeavour to treat all non-resident-owned assets in the same way irrespective of the date of their formation... Members shall endeavour to avoid introducing any new exchange restrictions of the movements of capital or the use of non-resident-owned funds... Members shall grant any authorization required for the conclusion or execution of transactions and for transfers specified..."<sup>321</sup>

The Code on Capital Movements was revised and amended several times, in order to include new developments and improve its explicitness in certain areas. While the right of establishment was earlier explicitly excluded from the Code, a 1984 amendment expanded the definition of inward direct investment. Of particular importance is the provision requiring member States not to maintain policies or practices in regulated sectors that will raise special barriers to non-resident investors. After entry, foreign establishments should be granted standards of treatment no less favourable than granted to domestic enterprises ("national treatment"<sup>322</sup>), and on a non-discriminatory basis. However, member States have

been permitted to derogate from certain liberalization measures, or to lodge reservations to them. This specially concerns the existence of "serious economic and financial disturbances" or the adverse developments of the overall balance-of-payments (Article 7). Regardless of the perceived long-term benefits from liberalization, the Code "shall not prevent" a member State to exercise its right to maintain public order, protect its essential security interests and fulfil its obligations related to international peace and security (Article 3).

Although extensive liberalisation has been accomplished, a survey of remaining restrictions shows that in particular the issuing of securities (and money market instruments), as well as their introduction on the secondary market is still not liberalized. In general, the reservations imply that permission is required for the operations concerned, rather than that they are absolutely prohibited. For example, Germany, France and some other countries restrict the issue of Eurosecurities, for the purpose of controlling the use of their currencies abroad. Other countries restrict the purchase of securities on the domestic market by foreigners, while some control purchase of securities abroad by residents.<sup>323</sup> It is worth mentioning that only four countries lodged no reservations: Canada, Luxembourg, the Netherlands and the UK.

The provision of cross-border financial services has been liberalized by an extension of the "Code of Liberalization of Current Invisible Operations". One of the significant differences in comparison to the Code on Capital Movements is the provision which calls for the extension of liberalization to other operations:

"Where Members are not bound, by virtue of the provisions of this Code, to grant authorizations in respect of current invisible operations, they shall deal with applications in as liberal a manner as possible."<sup>324</sup>

However, an important degree of discretion was again left to member countries for taking measures for the maintenance of fair and orderly markets, sound institutions and for the protection of investors. Particularly in relation to banking and investment services, most of the countries still require establishment on their territories.

Finally, the establishment of foreign banks has become widely accepted throughout the OECD (especially bearing in mind the efforts carried out within the EC and the related directives). The obligation to liberalise foreign bank establishment, on the same basis as national treatment, was included in the OECD Code on Capital Movements in 1986. Accordingly, countries would refrain from imposing new restrictions, and would progressively abolish existing ones. Nevertheless, most countries still apply the reciprocity principle: states reserve the right to approve the establishment of foreign banks on a reciprocity basis. For example, it is permitted by the Second Banking Directive in the EC regarding non-EC countries.

It is often argued that reciprocity provisions are a powerful negotiation weapon, particularly in inducing opening of other countries' markets. The opponents

argue that reciprocity is indeed a form of protectionism which could give rise to a "protectionist spiral", that it undermines the already achieved level of liberalization and formally introduces a discriminatory practice. Reciprocity is still a matter of dispute, but it is very likely that this component will be built in any multilateral framework for global capital flows. Within the OECD, only seven countries do not support the reciprocity principle. (Four of them do not support it even though they are EC members and are "allowed" to apply it under the EC Second Banking Directive.)<sup>325</sup>

The issue of liberalization of trade in goods has been in GATT's focus since its establishment more than forty years ago. Liberalization of services is a far more recent item on its agenda. At the 1982 Ministerial Meeting, it was decided at the initiative of the US that each contracting party with an interest in services should examine the sector at the national level and exchange information about that, both among themselves and through the GATT. Two years later, a set of Agreed Conclusions was adopted, initiating a process of information exchange in relation to services in GATT. At the Ministerial Session in Punta del Este in 1986, a Declaration was adopted launching the Uruguay Round of Multilateral Trade Negotiations. It was agreed that the negotiations on services would be separated from goods and would not be placed within the legal framework of GATT. For this undertaking, the Group of Negotiations on Services (GNS) has been established. It has been among the most ambitious projects undertaken to establish a multilateral framework of principles and rules for trade in services. Three main objectives were laid down in the Declaration: 1) expansion of trade in services under the conditions of transparency and progressive liberalization; 2) promotion of economic growth of all countries, and 3) promotion of the development of developing countries.

The GNS has proved to be a forum where completely opposite views on services, liberalization and economic efficiency have been presented. On one hand, developed market economies have been pressing for a wide and comprehensive liberalization, while, on the other hand, developing countries have been generally reluctant to open their markets for services. Their views are totally different also in respect to the basic nature and goals of a future agreement. The developed countries aspire at reaching a comprehensive framework, with specific rules in the form of a binding international convention, and with a dispute mechanism to request compensation in the case of breach of the rules.

"Without any specific rules of the game that countries should respect when implementing national regulatory regimes and policies, it would be difficult, perhaps impossible, to achieve most of the benefits that services now have to offer all countries."<sup>326</sup>

On the other hand, the developing countries oppose any kind of a comprehensive and binding arrangement, on the grounds that the service sector is rather "sensitive" and has a significant impact on macroeconomic conditions. They

do not see national regulation as being restrictive to global liberalization, but rather as being a necessary "barrier" to promote a country's development objectives. Most frequently, they perceive services as the instruments by which a country exercises its political and economic sovereignty. So, by liberalizing them (i.e. by opening up to competition from more developed countries), developing countries fear they would limit their governments' ability to carry out development policies. Furthermore, if services were to be brought within GATT, the same rules would apply for totally different environments and cross-linkages could be created between the trade in goods and in services. For example, a country could impose a condition that it would open up its markets for goods if the other country opened up its service sector. So, instead of introducing more equality, such a negotiating system could only lead to greater inequality, by limiting the autonomy of the development process.

"It appears that perhaps a thin layer of multilateralism with a large space for working the balance of advantage bilaterally might be a better approach. And, an approach in terms of guidelines would perhaps be more feasible than an approach in terms of mandatory, legal, contractual arrangement."<sup>327</sup>

In spite of major, conceptual disagreements between the two groups of countries, it is particularly interesting to outline the basic principles that have been offered<sup>328</sup>. Firstly, services should be subject to the "appropriate regulation" which links the concepts of progressive liberalization and respect of national policy objectives. So, services should be liberalized but within the limits set out by "general objectives" such as national security, sovereignty, the ability to conduct national policies (e.g. a development policy), and the maintenance of law and order. Other principles include: non-discrimination (most-favoured-nation-treatment in GATT), standstill (preventing moving "backwards"), transparency of regulation, and respect for development objectives.

The progress on negotiating the framework for services has been rather slow, due to the already mentioned divergence among the developed and developing countries, but also due to the existence of several practical questions still to be settled. For example, it has not yet been decided which industries or subsectors are to be covered. An agreement has not been reached upon a proper definition of trade in services: developed countries propose that it should include both trade (when services actually cross the frontier) and foreign direct investment in services (when a supplier is actually present in the importing country). Developing countries oppose this position, fearing that it would completely open their "infant" service markets. However, a debate that has emerged in the GNS clearly points out that the "classical" principles to provide comprehensive liberalization have to be reviewed.<sup>329</sup> In December 1993, the Uruguay Round was completed, but services were left out of the agreement.

The European Community's approach to the issue of liberalization dates back to the early 1960s, when the Council of Ministers adopted two Directives for the lifting of restrictions on capital movements in the Member States. This primarily concerned short-term and medium-term credits, investment, personal capital movements and trade in quoted securities. Other operations, like issuing bonds and long-term loans, were deregulated conditionally. Liberalization of these financial transactions was not sought *per se*, but rather as a necessary condition for the development of the common market. However, in 1964, the Council of Ministers rejected a proposal for a third Directive which would have eliminated the remaining discrimination in national legislation. Great dissimilarities continued to exist, particularly regarding the issuing and placing of securities, stock exchange listing and the acquisition of securities through financial institutions.

For more than two decades, the issue of liberalization stayed dormant, and even new restrictions were imposed on capital movements and banking services. Many wider economic problems accounted for this: massive (speculative) capital flows from the US, the long-run crisis of the dollar, two oil crises and the related balance-of-payments problems, etc. The beginning of the 1980s brought new initiatives to take the issue back to the EC agenda, particularly bearing in mind the early success of the European Monetary System (operating from 1979) and a rapid global integration of capital markets occurring at that time. A 1985 White Paper outlined the basic approach that could be taken in order to bring about a European Financial Common Market, and the issue of liberalization of the financial sphere was considered in a comprehensive way. A new policy in this respect was to be governed by three major principles: minimum coordination of individual national rules, mutual recognition and home-country control.

Another important development has to be mentioned here, because it later proved to be of particular significance in negotiating and adopting the EC banking regulation. A revision of the EEC Treaty came into force on July 1st 1987 as the Single European Act, introducing majority decisions for numerous questions, including in relation *inter alia* to the common financial market. Nevertheless, decisions on fiscal matters, which are also fundamental for creation of the financial area, remained subject to unanimity. Bearing in mind the whole spectrum of banking traditions within the EC, this revision laid the grounds for some of the most fierce political debates concerning banking regulation.

During 1987 and 1988, capital transactions were further liberalized, so as to include long-term credits, the acquisition of unlisted foreign securities, the admission to the capital market of securities issued in another EC country, short-term and money market instruments, etc.<sup>330</sup> Nevertheless, a special safeguard clause was maintained to enable Member States to take protective measures if their monetary or exchange-rate policies are disrupted by liberalization.

An extensive liberalization of banking services began in 1973, when the



freedom of establishment was introduced, reaffirming the principle of non-discrimination. The first Banking Coordination Directive was adopted in 1977<sup>331</sup>, setting out an important additional principle of home-country control. For the first time, a reference was made to the level and adequacy of a bank's own funds (Article 6). In 1988, the Second Banking Directive was adopted<sup>332</sup> to promote the freedom of establishment and the freedom to provide financial services, both viewed as essential prerequisites for the achievement of the internal market. The Directive introduced a "single passport" for credit institutions:

"... by virtue of mutual recognition, the approach chosen permits credit institutions authorized in their home Member States to carry on, throughout the Community, any or all of the activities listed in the Annex by establishing branches or by providing services;"<sup>333</sup>

A bank with the "passport" is permitted to conduct a whole range of activities, ranging from "pure" credit operations (e.g. consumer, mortgage and other credits), to participation in share issues, portfolio management and advice. This is subject to the provision that the institution is authorised to carry out the services at home. Such an extension of the regulation to permit the engagement in most investment services implied that the process of regulatory harmonization had to include investment banking as well. Despite all the underlying preferences for liberalization, the Directives mainly concern the internal area, i.e. have been designed to provide liberalization among the Member States. Nevertheless, the opening up to other, non-EC countries can be seriously affected by the application of the reciprocity clause, when the status of a bank from a third country is made "negotiable" and conditioned by the status and treatment of EC banks in that country. The latter will cover situations when EC banks are not ensured genuine national treatment, effective market access and competitive opportunities comparable to those offered by the EC. This provision has attracted most controversy, in relation to many of its aspects and elements. It has been argued that it serves to build a "Fortress Europe" and that the concept of "effective market access" has been deliberately left vague enough to permit different explanations. Sometimes, it has been claimed, it can be used as a powerful political "leverage" to achieve other objectives. The following statement made by Sir Leon Brittan in the US may illustrate such a perspective.

"The Community, like the US administration, is fully committed to the objective of liberalizing banking and financial markets at home and abroad. The US administration has consistently supported the Commission's efforts to create the single market by 1992. The Commission equally supports the drive of the US administration to deregulate and reform banking and financial markets here. With mutual support and hard professional work we should be able to arrive at the same destination at the same time."<sup>334</sup>

Concerning a single securities market, efforts to harmonize regulation in this field date back to the early 1970s. It was agreed that information asymmetry

constitutes an important barrier for capital movements, and hence for market efficiency. Furthermore, it was realized that adequate information disclosure can significantly improve the protection of investors, and that such disclosure requirements should be uniformly designed throughout the Community. Most of the Directives adopted since 1979<sup>335</sup> aim at improving market transparency and investor protection.

Two Directives from the second half of the 1980s are of a particular importance for this analysis. In 1985, a Directive was adopted to harmonize regulation and liberalise activities in relation to transferable securities (units issued by investment funds)<sup>336</sup>. It was a milestone decision that required all the restrictions on the free marketing of units to be removed. Another major decision was to permit the automatic stock-exchange recognition of listing particulars, once they have <sup>been</sup> compiled with the 1987 Directive coordinating such rules.<sup>337</sup>

So, by the end of the 1980s, a substantial degree of regulatory harmonisation had been achieved, already allowing much more liberalized securities flows within the EC. However, as credit institutions were granted "single passport", countries with a developed investment banking sector started to press for a similar freedom for investment banks. The strongest advocate of this has been the UK, with not only a long investment banking tradition, but also with a substantial share of international and global securities business being conducted there. So, in February 1990, the Commission received a proposal for an Investment Service Directive (ISD)<sup>338</sup>. Similar to the Second Banking Directive, the ISD will allow credit institutions to offer investment services in any Member State on the basis of a licence held in one state. It is designed to set minimum conditions for such authorization, and to set the conditions under which an authorized investment firm can establish its branches or provide services in another Member State. According to the Annex of the Directive, liberalization covers activities such as broker and dealer operations, market-making, portfolio management, underwriting, operations on derivative and money markets, etc.

Two basic principles of EC regulation, home country control and mutual recognition, have been reiterated, as well as the reciprocity clause in relations with non-EC countries. So, the authority from a state where a bank is registered (home-country) will supervise the bank's compliance with a number of rules, concerning the initial capital required, the adequacy of its "own funds" and sound management. Furthermore, the home country authority will supervise continuing observance with prudential rules: for the purpose of investors' protection, dealer operations (when the firm is the principal) have to be kept separate from broker-activities, and the firm shall be required to have sound internal control mechanisms. The firm shall be required to establish its own investor-compensation scheme or to be a member of a general arrangement in that respect. The host country authority, however, will continue to be able to impose conduct of business and other consumer protection

rules within certain limits.

Concerns that were expressed, in relation to the ISD, on behalf of many actors involved were numerous and diverse in nature, and they clearly highlighted how perceptions vary. For the German government, the Directive had become a "safeguard" to protect local universal banks from fierce competition on the EC securities market. This was done through making the adoption of the Directive conditional: securities flows could be liberalized, but only if investment banks were to fall under capital rules similar to those devised for credit institutions. Large universal banks, therefore, would not be forced to accommodate to investment banking patterns, but instead investment banks would have to augment their balance sheets. Resulting from the EC banking directives (CAD, Large Exposure Proposal, Own funds, and Solvency ratio), what came into question here was whether to allow EC-wide and unfettered competition, or to "channel" market forces for the ultimate goal of improving efficiency. The position of the German government in this case was much less related to the issue of liberalization, and maybe more connected to a particular promotion of the value of order - German-style regulation of the EC financial market place.

British banks took different positions in relation to many "unallocated" stakes, particularly those regarding the operation of market forces, and also linked the values of equality and wealth (efficiency) to the issue. What was of a high salience for them was the question of liberalizing both segments (or types) of markets - regulated and unregulated. A bank should be free to choose where it could conduct its business (within the EC), but it could not fully exercise this right if the transactions had to be carried out solely on regulated markets. The reasoning behind this is that the "order-driven" market, as exists in the UK, already protects investors by imposing rigid dealing-rules and codes of conduct. So, the market itself had created certain conditions for promoting the value of order, and hence there was no need to rank this value higher than the one of freedom, or even efficiency. British banks were also pressing for certain changes in relation to market transparency and information disclosure, as well as concerning direct access of banks to stock exchanges and other markets.

However, the Investment Services Directive was adopted in May 1993 and is due to be implemented in the member states at the beginning of 1996.<sup>339</sup>

An additional remark has to be made in relation to the political fight over EC banking regulations. Namely, most of the so-called "national" banking and merchant-houses associations link together not only domestic institutions but also the foreign ones operating locally. So, one can conclude that the views of "British banks", as described above, are not exclusively held by the institutions originating from the UK. Most of such views are shared by important American, German or Japanese banks that carry out a substantial portion of their international business through London. This may add a new perspective on cross-border competition, and

yet another perspective on global politics.

These three approaches have been chosen in order to illustrate how different international organizations (in the widest sense, as regular patterned interactions) perceive the issue of liberalization v. protectionism. Most actors described in the previous chapter feel the issue as being very salient to them, but to include a survey of all the attitudes and views would require an unreasonable extension of the analysis. Nevertheless, it can be concluded that the strong controversies surrounding this issue underscore the very basic perceptions (values) and questions (policies) in relation to the market economy: to limit or promote market forces, to regulate or deregulate market forces and/or market participants, etc. Some actors perceive these stakes as being related for realisation of the value of freedom, others discern them as serving the protection of order, and yet others feel them as contributing to greater or less equality.

When it comes to policy norms and questions, positions are also quite divergent, despite the fact that the most general principle (belief) is not contentious: the global securities market should be kept as open as possible, because of the overall economic benefits. However, the development of policy norms (which is a necessary precondition for a regime creation) is still hindered by this qualification "as much as possible". Here, governments' traditional concerns with sovereignty come in again. The extent to which openness is feasible (reasonable, viable) depends on the country's government and its assessment of "national objectives". Those objectives rank from national security, balance-of-payments stability, to orderly market functioning, industrialization and service development, etc. Furthermore, a government's discretionary assessment is accompanied by a range of "weapons" it can use: reservations on agreed multilateral frameworks, suspension of some of the measures deriving therefrom, or the reciprocity clause. However, one cannot neglect the impact of other, non-governmental actors, but their actions are most often only directed to their governments, i.e. to the representatives in international organizations.

#### **7.2.4. Market standards**

Another aspect of the global securities market is its quality, meaning the easiness and cost-effectiveness of making the market transactions, the breadth and depth of the market, its reach and stability, its flexibility to accommodate to changing financial needs, etc. In addition, a broader sense of market quality implies another dimension: prudent behaviour and the code of business conduct. If one studies carefully each of these market dimensions, it becomes plain that what is essential and common to all of them is the question of market standards. The capital

rules, described above, can also be regarded as a sort of standard which should (at least, that was the underlying intention when they were agreed upon) improve the market quality. However, in this study, they were analyzed in the context of international control - as the instruments of control. Now, the analysis will focus on a group of market standards which are very different in their nature, but are still expected to be important in creation of any future international regime for securities flows.

A code of business conduct has always been one of the pillars of banking systems developed in a more liberal tradition, what has been termed here as the "confidence" approach. Designing such rules has been regularly carried out with close cooperation among all the "parties" involved: banks and practitioners, banking associations, regulatory authorities, and investors and customers. Maybe that could be the reason why such rules have most often invoked a high level of compliance (some of those arguments have been presented in relation to the self-regulation/statutory regulation debate). Nevertheless, the most important consequence resulting therefrom is undoubtedly a higher predictability of other actors' (market participants') behaviour and attitudes. By reducing an important dimension of uncertainty, such rules can significantly improve the market quality. In the case of global financial markets, uncertainty is especially accentuated due to various financial traditions, backgrounds and environments which are globally integrated.

During the 1970s, when the expansion of transnational corporations was occurring rapidly, many actors on the global scene became aware that certain international "rules" for that expansion must be created. In the absence of any supranational authority, such rules could not be of a binding character, but instead could take a form of "guidelines" - directed to both transnational firms and host-country governments. The issue of liberalization v. protectionism as regarding foreign direct investment was placed very high on the agenda, and business conduct was analyzed from that perspective. International efforts to implement rules regarding direct foreign investment and the conduct of the agents of such investment date back to the proposed Charter for an International Trade Organization, prepared in Havana in 1948.<sup>340</sup> The Charter (which was never adopted) dealt with restrictive business practices, promotion of an investment climate, monitoring of foreign investment, etc. During the following two decades, the UN became the main forum for dealing with these questions, and several important resolutions were adopted.<sup>341</sup>

Outside the UN, the Organization for Economic Cooperation and Development has issued, in 1976, a set of "Guidelines for Multinational Enterprises"<sup>342</sup>. These Guidelines consist of recommendations to both transnational firms and host countries, and actually present a "model" of behaviour expected from such firms. For example, enterprises should take fully into account the policy

objectives of the host country, publish consolidated financial statements, disclose the structure of the firm, refrain from disturbing local competitive structures, and take due account of the need to protect the environment. Although these Guidelines are voluntary and of a very general nature, it is important to notice that they present the first, multilaterally agreed framework for a global economic phenomenon.

Another highly-politicized framework for such activities has been negotiated by the UN Commission on Transnational Corporations since 1974. Once adopted, this rather ambitious code would cover general aspects of the firm's behaviour (e.g. respect for national sovereignty and domestic laws, adherence to economic goals and socio-cultural objectives, respect for human rights, etc.), as well some special aspects (economic, financial and social). The draft text also calls for the disclosure of financial and organizational information about the whole of the enterprise, and emphasizes the need for intergovernmental cooperation and information exchange.<sup>343</sup> Most of such internationally-designed codes aim at improving the general economic environment by, for example, opening up national markets for foreign investment or introducing more equality among domestic and foreign firms. Although the underlying motives for these codes have not been an improvement of the market quality, they are important for this study for at least two reasons. Firstly, they point out a rising awareness of the "world community" that global problems are different from international problems, and that they should be dealt with upon widely accepted (shared) principles. Secondly, these codes mostly address the firms themselves, because, it has been realized, without their voluntary adherence to such recommendations any international regulation is unproductive.

Concerning conduct of financial business, particularly in the securities markets, the early work in the EC on a European code of conduct<sup>344</sup> is very significant. The explanatory memorandum states that, in order to promote harmonious economic development, the role of the securities markets is to provide adequate matching of supply and demand for capital. Therefore, it is absolutely necessary to create conditions for the proper working and integration of these markets. Keeping in mind that the recommendation on a Code was made in 1977, this was really a "fresh approach" to the capital market in general.

"...the Commission is anxious to take full account of the dynamics of the financial market and of business life, and consciously to adopt a positive attitude which seeks to improve the machinery of the market and the effectiveness of those operating on it."<sup>345</sup>

The Code is not addressed directly to firms operating on the securities markets but instead to their supervisors, setting out a fundamental objective, certain general principles and a number of supplementary principles. The objective is to

"...establish standards of ethical behaviour on a Community-wide basis, so as to promote the effective functioning of securities markets (i.e. by creating the best possible conditions for matching supply and demand for capital), and

to safeguard the public interest."<sup>346</sup>

The first general principle recalls that any securities transaction has to be carried out in accordance with host-country rules. In order to reduce market imperfections (asymmetries), fair, accurate, clear and adequate information should be made available to the public. Equality of treatment should be guaranteed to all holders of securities of the same type issued by the same company. Companies' supervisory boards, directors and managers should avoid any action expected to hamper the proper functioning of the market. Moreover, any professionally engaged person should avoid jeopardizing the credibility and the effectiveness of the market, and should endeavour to avoid all conflicts of interest. In addition to these basic principles, the Code further sets a number of supplementary principles, e.g. concerning 'fair behaviour' by financial intermediaries, the recommendation to carry out activities on organized markets, avoidance of price manipulation and establishment of "chinese walls", and the publication of information.

In 1990, IOSCO adopted a Resolution on International Conduct of Business Principles<sup>347</sup>, and called upon all its members to recognize them as basic standards for financial firms in their activities on the domestic as well as the international level. These principles are honesty and fairness, diligence, the use of all capabilities and resources, information about customers, information for customers, conflicts of interest, and compliance. So, to explain these principles briefly, firms are expected to conduct business activities in an honest and fair way, i.e. to avoid misleading and deceptive acts or information. Moreover, they should have the duty of best execution (i.e. they should seek to execute the orders at the terms most favourable to the customer), and should effectively use all the necessary resources and procedures for proper business performance. One of the ways to ensure proper market functioning is to provide adequate flows of information: firms should seek financial and other information from their customers, and should disclose relevant information (e.g. about risks) to customers. Finally, firms should comply with all regulatory requirements applicable to the conduct of business.

The most important feature of this conduct is that it covers financial operations on both the domestic and the international level. However, these principles are directed only at the brokerage firm-customer relationship, while other types of relationships have been neglected.

This "omission" was corrected in 1992, when the International Federation of Stock Exchanges adopted its own set of principles for securities business conduct.<sup>348</sup> An earlier version of these principles was accepted in 1988, containing very general principles for securities trading. They included rules and recommendations with respect to stock exchange membership, traded material, trading process, and clearing and settlement of transactions. The 1988 Principles were further elaborated four years later, taking into consideration the IOSCO principles of business conduct. The scope of application was widened to cover the

relationships between: 1) stock exchanges and their members, and their employees; 2) stock exchange members themselves, and 3) stock exchange members, and their customers and employees.

The 1992 Principles resemble the IOSCO ones to a great extent, but are far more detailed and developed. The principles cover almost all aspects of business conduct that may affect the relations mentioned above: honesty and fairness, diligence, professional capabilities, disclosure of information, conflicts of interests, and compliance with statutory (government) and self-regulatory obligations. For example, firms (members of a stock exchange) should conduct their business with honesty and fairness in order to honour the integrity of the pricing mechanism, which is the most important function of any exchange. For that reason, they should avoid misleading acts or representations, refrain from disrupting the market, test new trading strategies, and promptly report transactions. Considering the capabilities principle, the FIBV expanded it to include financial responsibility rules for firms, and the duty of an exchange to monitor its members' financial positions. So, due attention was paid to the complexity of the organized securities markets, but still their global integration was hardly mentioned. Similarly to the approach taken by IOSCO, what was in focus was the international market, organized and controlled by national securities authorities.

Regardless of their scope and underlying intentions for their creation, all of these principles fail to include one particular aspect of global securities and global finance, money laundering. It can be argued that such activities have already been outlawed, and that codes of conduct should relate only to legal or permitted operations. Banking associations in some financial centres (e.g. BBA in London) have adopted special guidelines in this respect, which would eventually be included in their codes of conduct.<sup>349</sup> Various international fora deal with this problem and it has indeed been placed high on many agendas. However, as the questions of how to detect and prevent such an abuse of the global financial system are rather complex, the scope of this analysis remains limited to "standard" securities market transactions.

### **7.3. Conclusion**

This part of the analysis has attempted to present the complexity of the issues related to the global capital market, in order to illustrate formation of the global agenda. Even after such a lengthy presentation of the "actual" state, it is difficult to conclude whether there is one global agenda, or different issues are placed on different international agendas. Due to very strong functional linkages between the issues, one can assume that there is a single, world-level agenda where most of the



critical stakes in relation to capital flows are being debated. Until the end of 1992, none of the three issues has reached the decision making stage, and it is disputable whether they have entered even the ritualization phase. However, after a careful and detailed comparison of the advance made on each of the issues, it is possible to summarize a group of basic beliefs that underlie these political processes. If this is taken as a body of principles and norms to govern actors' behaviour, one can assume that there are certain conditions for a broad framework for global capital flows to emerge. The following description may be criticized as being too simplistic, but it had to be done in such a way in order to fulfil the main purpose of the second part of the analysis: to give another perspective, complementary to the basically economic phenomenon.

The basic values which are to be protected are wealth, order, freedom and development. National regulators, for example, perceive the global integration of capital flows as threatening the basic value of order; most banks see that phenomenon as opening new opportunities for an enhanced satisfaction of the values of freedom and equality; international governmental organizations consider it mainly as one of the alternatives for improving the overall economic efficiency (the value of wealth). Actors' ranking of the values, as the essence of politics, is definitely not fixed and differs to a great extent. What is common to all actors is that they feel the need for collective action, either to avoid joint losses or to achieve joint gains. It is possible to outline several basic principles that would eventually guide a regime for global capital flows.

Firstly, national authorities should fully cooperate in supervision of transnational banking. This can be further elaborated through a set of norms, such as: 1) no transnational activity should be allowed to escape supervision; 2) such supervision should be carried out on a consolidated basis, so as to provide control of the whole of a transnational bank; 3) cooperation among national authorities should be as extensive as permitted by the limits of national laws and public policy; 4) international regulation should not impose excessive burden on market participants, and thus adversely affect the market efficiency.

Secondly, the market stability is crucially influenced by the level of soundness of transnational banks. For the protection of the values of order and security, international regulation should develop a set of widely-accepted standards for assessing the financial strength of banks. Possible norms which should "fortify optimal solutions"<sup>350</sup> may be: 1) financial institutions should maintain adequate capital against their operations; and 2) the adequacy of capital should correspond to different risks inherent to transnational financial operations.

Thirdly, protectionism can greatly reduce overall economic benefits, so national markets should be open to non-nationals. This widely-accepted general orientation needs further clarification, and hence a set of norms would eventually be developed, as to include the following: 1) banks should have the freedom of

establishment and operation; 2) there should be no discrimination between domestic and foreign banks; 3) countries should be allowed to limit the level of market openness under certain, well defined conditions, and 4) the achieved level of global openness should not be decreased.

Fourthly, efficiency of the market is primarily determined by adequate business conduct of transnational banks. So, in order to protect the value of wealth, behaviour of all actors should be guided by the following norms: 1) in carrying out their financial operations, banks should comply with the highest ethical standards; 2) an adequate level of market transparency should be maintained; and 3) investors should be granted appropriate protection from derogation of the two previous norms.

This may give an impression that all the basic principles and norms are accepted universally and in all details. Nevertheless, as this chapter has presented, there still remain many stakes under contention, and a final disposition of them may significantly affect the whole structure. As the environment and the actors themselves are permanent sources of issues, future developments can generate new issues. Also, some of the old issues can be taken off the agenda, either because certain interim dispositions will be made, or an issue will become dormant. In addition, if a prospective regime is to become operational, a body of rules and decision-making procedures will have to be created. At present, there exist certain rules in relation to, for example, reciprocity, the location of the main supervisor and derogation from the norms (e.g. under which conditions a member-country can derogate from the norms of the OECD Code of Liberalization of Capital Movements).

From the theoretical point of view, an important conclusion can be drawn in relation to future development of the global capital market. Apart from the impact of broad economic trends, that development will be crucially affected by the "high politics" of global securities flows. One of the possible outcomes of such a global political interplay may take the form of a regime to govern the market. In the absence of a world government, but also far from anarchy, one can expect that some sort of multilateral agreement on the "rules of the game" will be reached. The concluding part of this analysis strives to justify this conclusion.

## **CHAPTER EIGHT: FROM INTERNATIONAL ECONOMICS AND INTERNATIONAL POLITICS TO THE GLOBAL MARKET**

The doctrinal history of economic thought is loaded with lengthy and thorough analyses of all kinds of phenomena from this sphere of social development. These analyses have usually been carried out within the strict confines of the single discipline. Sometimes these borders have been narrowed and sometimes expanded, but it has been widely accepted that, for example, basically economic phenomena should be studied by economists, using "tools" of economic analysis and relying on findings of economic theory. The strength of tough academic resistance to wider research horizons definitely is derived from a variety of reasons. Nevertheless, the speed at which new, unknown phenomena arise in all aspects of human life has significantly contributed to the challenging of this intellectual rigidity. Concerning over-all social development, recent decades have particularly emphasized the speed and diversity of change.

The ultimate goal of this analysis has been to offer one of many possible dimensions within which basic economic and political research could be broadened and presumably be enriched. It is not aimed, however, at denying the "scientific sovereignty" of the disciplines concerned. It rather aspires to illustrate a way in which the disciplines' grounds could be fortified - by making them more responsive to the real-world changes.

As pointed out in the introduction, this analysis has a two-fold purpose. For economists, to help them realize that beside a quantifiable world of interest rates and exchange rates, there exist other - subjective and axiological - motives for action. For political scientists, to contribute to their better understanding of sources of political issues: in order to comprehend the rise of certain economic stakes and issues, they should pay due attention to economic analyses of the environment to political systems, macroeconomic factors and basic economic and market structures. Although this study is divided into two parts, this has not been done for the purpose of maintaining the demarcation of the research lines between economics and politics. On the contrary, an attempt has been made to extend the analysis over and beyond rational-choice explanations (for the first part) and exclusively political considerations (for the second part).

The main analytical assumption has been that modern economic phenomena must be studied within a multidisciplinary framework, because both their origins and their consequences relate to various aspects of social life: economic, social,

political, cultural, technological, etc. In this particular case, such a framework has been built mainly upon the economic and political perspectives of the same phenomenon, notwithstanding some broader sociological and technological aspects drawn upon at times. In addition, a critical research attitude has been taken, implying that institutions and social and power relations have neither been taken for granted nor analyzed within a static setting. So, the analysis has concerned itself with the origins of and changes in the phenomenon of the global capital market, maintaining the postulate that it is the social and political complex as a whole, which should be researched.

As there is no single, widely-accepted definition of the global financial market-place, it is not possible to offer a concise interpretation of the global capital market. Instead, one has to rely on integrating the findings from various analytical dimensions, such as the market's origins, structures, segments, participants and/or its coverage.

Modern financial markets have emerged as the main outcome of a "financial revolution" of the 1970s and the 1980s, although international financial transactions have been practised since ancient times. Today, financial markets do not just serve the "real economy" but lead a life of their own, sometimes quite separate from national and international economic trends. Nevertheless, they most often epitomise the very nature of dynamic processes at all levels of economic functioning - at the national, international and global levels.

Traditionally, financial markets intermediate between dislocated supply and demand for financial assets, they connect different market participants, and bridge the time-gap between supply and demand. In this way, they provide the continuity of asset accumulation and allocation. One of the criteria for categorizing financial markets is the scope of their operations, so there are domestic, international, off-shore, multinational and global markets. The first two categories had dominated the most part of financial history: financial circulation had been successfully kept within state borders and under state governance. An ever-growing economic expansion in the latter part of the XXth century has broken many such restraints and even more it has transcended borders. Global financial flows have come to be pre-eminent, shaping and determining economic developments at all levels. Among various such financial flows, capital flows have proved to be of particular importance.

The global capital (securities) market today presents a cluster of institutions, instruments and participants all related to allocation of capital simultaneously on different domestic, international, multinational and off-shore markets. As with most of the other modern financial markets, it features a huge volume and frequency of transactions with a high degree of concentration and centralization. It is also very flexible and responsive, and characterized by both competition over interest-rates and a non-price form of competition (e.g. competing by the quality or the range of products offered). It creates an environment conducive for financial innovation, but

also for speculation. Bearing in mind a high level of the world-wide integration of such flows, as well as the vital significance of adequate capital allocation for any level of economic operation, the systemic risk has been greatly elevated. This is one of the distinctive features of the modern, global securities market, particularly in comparison to the previous stages in the development of international finance.

The global securities market came as a logical result of the financial and macro-economic inefficiencies of the capital flows on purely domestic and international markets. For example, balancing the needs for capital and for investment in size, time and place could not be adequately carried out exclusively within limits of domestic and international transactions. Keeping in mind a high level of world-wide economic interdependence, globalization of securities markets can indisputably contribute to a more realistic asset and risk valuation, in comparison to an assessment made by relying exclusively on domestic and international markets. Furthermore, the adjustment of market participants' portfolios to changing needs certainly requires access to different markets, as well as the use of financial techniques to combine various capital sources and instruments. Traditional domestic and international financial transactions, as well as the scope of traditional financial markets, cannot provide an adequate basis for cross-border mergers and acquisitions. In short, globalization of financial flows has become a prerequisite for the market to continue performing its functions efficiently. The global capital market today allows, much more than all the other markets, market participants to raise or to invest long-term funds in an appropriate volume, under acceptable conditions and at the right time.

Globalization of securities flows have been conducted along two major paths: the internationalization of domestic markets, and the proliferation of various off-shore (Euro) markets. A progressive internationalization of domestic markets has included, inter alia, the expansion of the foreign-securities sector, easier entry regulations, dismantling of institutional barriers in the market, creation of new instruments, etc. The rise of different off-shore markets has marked a new financial era. The imposition of capital controls in the US in the beginning of the 1960s actually led to the creation of the "Euro-dollar escape valve", which later paved the way for the other Euromarkets to emerge. In the absence of any kind of supranational regulatory authority, but also under the conditions of "competitive" deregulation by a few countries, such "stateless" markets began to flourish. Oversimplifying, global securities flows today relate to issuing and trading various foreign and Eurosecurities, combining in that way different international and extraterritorial transactions.

However, the global capital market encompasses much more than certain quantifiable amounts of such securities. This new phenomenon embraces comprehensive integration of domestic securities markets, a remarkable diversification of various external markets, the emergence of new techniques and

instruments that are globally accepted and used, harmonious reforms of major stock exchanges, a progressive integration of emerging markets, an increase in the number of currencies of denomination (i.e. other than the dollar) and improvements in technological support. So, by its very nature, it is not a static phenomenon, but rather a process which integrates these developments at the global level.

The structure of market participants is highly diversified, and includes large commercial and investment banks, institutional and private investors, financial houses of industrial corporations, governments and intergovernmental organizations. However, major investment banks are certainly the most active participants in the global intermediation process. Their transnational expansion is of a more recent origin, in comparison to the expansion of commercial or universal banks, but of no less reach and importance for the functioning of the world economy.

Modern investment banks feature some distinctive characteristics that have greatly influenced the nature and structure of the global capital market. They integrate previously separated functions on the securities markets, they are heavily dependent on a high level of innovation and individualism, and they rely on their brand name and their reputation as the main competitive weapons. Investment banks have always been very flexible and "customer-oriented" financial institutions, where the customer's confidence and the bank's ethical code of conduct have been highly valued. Finally, they have always depended on the "real-time" information, which is crucial for guiding investment business decisions. Precisely on these grounds, advances in the telecommunication and computer industries have become the main infrastructural components of the market. So, as a result of their transnational expansion, such features have been, more or less, "projected" to the global securities market place.

Nevertheless, this has not been the only factor to determine the features of the global market. As underscored, a new quality of the market derives from the integration of various domestic and international markets, each with its own peculiarities and traditions. A lack of confidence in banking and finance in the US, a long standing tradition of self-regulation in the UK, a strong government influence and tight links between industry and banking in Germany, as well as quite static and centralized structures in Japan - all these traditions, and many others, were mingled once capital flows had become globalized.

This new quality can be viewed in two ways which are not mutually exclusive. On one hand, it can be perceived as a positive aspect of the market's development - a variety of institutions, attitudes and traditions contributes to expanding the range of choices. On the other hand, such a feature can be observed as increasing uncertainty, allowing excessive speculation and fraudulent practice, and creating conditions for arbitrage beyond basic economic reasons. From the point of view, such a market definitely serves an ever-efficient allocation of capital on the world-wide basis. From the other point of view, that kind of global financial

"chaos" elevates the systemic risk beyond a "controllable" level, and in that way greatly diminishes benefits from the rise in efficiency. The existence of these two broad perspectives on the same phenomenon has generated another new, distinctive feature of the market: global financial flows have become politicized to an extent hardly ever before associated with any kind of financial transactions (with the exception of exchange rates).

Financial market operations spanned the globe, significantly contributing to the growth of integration and interdependence of national economies. Nevertheless, it was not until the 1982 debt crisis that global financial transactions were perceived as a potential threat to the stability of both the global system and the individual, national economic systems. Since then, perceptions of global linkages, international responsibilities and actions have been undergoing radical change. National policy objectives have been re-assessed, as well as the ordering of national priorities. It has been realized that finance is no longer just the concern of domestic policy, and particularly not just under the domain of economic policy. International financial problems have increasingly come to be seen in the same terms as traditional international relations, i.e. foreign policy. Rising awareness of major industrialized countries that an innovative, global approach to international finance should be taken laid the ground for a new stage in international cooperation and policy formulation. However, such growing awareness has proved to be just a necessary condition, but not a sufficient condition, for formulating and implementing international policy. Differences that exist in the concretization of awareness, for example in relation to objectives, strategies and actual implementation measures, have contributed to the emergence of a world-wide political debate.

Four particular episodes have been used to illustrate the rise of international concern in the field of global finance. In 1982 the world community, especially big creditors to developing countries, faced a crisis of a size, reach and complexity never experienced before. Many commercial banks, as the main creators of international liquidity at the time, had not been able to resist new profit-raising opportunities and had become deeply involved in sovereign lending. It was suddenly realized that a potential default of any of the banks would not be another bankruptcy case. Such an incidence would have severely endangered national financial structures and the international financial system as a whole.

The evolution of responses to the debt crisis closely followed changes in perceptions about actors responsible for the crisis, as well as about ways and means available to manage the crisis. In the beginning, there were just commercial banks - creditors to developing countries - to assemble short-term emergency packages. Later, the multilateral financial institutions became involved, along with international non-governmental actors, the banks' home-country governments and particularly the debtor country governments. Alongside a greater reliance on market forces (e.g. in developing new techniques for debt-relief), all the involved actors

realized that the strategy should be a long-term and comprehensive one. A consensus was reached upon the nature of the problem: the main causes of the crisis were of a structural, not temporary origin. It was perceived that the approach should focus more on economic conditions and performance, and not be limited to the "financial world". As the crisis pointed to a high level of global economic interdependence, the only form of a response to it could be multilateral action (though the West did not acknowledge this until 1985). Another important message was sent out by this episode: some of the basic financial market functions had to be re-examined, from the aspect of both national and international regulation. It became clear that government had acquired a "new" role of balancing a different type of national interests and goals, both at home and abroad.

The 1987 stock market crash was another dramatic experience that changed many general perceptions of the global financial structure and of the securities market functioning. This episode could be considered as a "final drop" for all actors to realize that capital flows were not just international transactions, but that the global capital market had indeed emerged. Enormous wealth was lost during the crash, but so were some long-held beliefs about the market. It was discovered out that signals from the market can often be insufficient, confusing or just too late. It was discovered that financial diversification had not laid the grounds for risk reduction, sufficient for the conditions of global integration. Computerized securities transactions emerged as powerful and "efficient" links in transmitting market disturbances across the globe. So, these features of the global securities system, highly praised in times of a "bull" market, turned against the system itself.

The crash explicitly underscored the high sensitivity of the market both to its economic and to its political environment. It became evident to what extent a lack of communication between major market participants, including the regulators as well, could induce a series of chain reactions. The crash also emphasised that such reactions were almost impossible to control, on both a national and a global level. Moreover, it highlighted a significant level of overall interdependence: the economic, trade and financial interdependence. Building and maintaining an adequate infrastructure for market operations (e.g. clearing and settlement mechanisms) came into focus. Even the imposition of certain market safeguards, it was realized, could be effective in the absence of a coordinative action to regulate and control different markets.

So, the debt crisis and the 1987 stock market crash have provoked a re-examination of some of the basic functions of the financial market, namely allocation of funds and production of information. The Banco Ambrosiano episode and the BCCI affair, among other similar incidents that were not reviewed, shed another light on the global financial market place.

The BCCI collapse was the world's biggest banking failure in modern times, concerning not just the amount of losses but also the number of countries,



organizations and individuals involved. The bank's business evolved mainly in the field of international trade-finance, where the speculative and fraud skills of its management were combined with its "opaque" transnational structure. As the investigations revealed after its closure in 1991, BCCI was conducting a vast range of criminal activities, such as money laundering, illegal acquisitions, maintaining relations with drug cartels and terrorist organizations, bribery, falsification of records and the conduct of imprudent credit policy. Such a scale of "business diversification" was made possible by many factors, most important being related to a lack of cooperation among national regulators, and to a lack any comprehensive and consistent regulatory framework for such organizations.

This incident launched some of the most thorough and substantial analyses of modern banking. Almost every aspect of international banking has come under scrutiny: banking structures and financial techniques, accounting practice, auditing and supervision, legal aspects, cooperation and communication among governments (and among departments of the same government), and, most notably, international regulation. It has been realized that a global approach, not just the inter-national approach, to modern banking should be developed. Such a strategy would have to encompass not only a great number of financial regulators, but also to include cooperation with the global banking community. It also should provide links with the regulators dealing with other issues such as terrorism and drugs. Most importantly, it should be based on a set of widely-accepted norms and rules that would clearly distribute rights and obligations among and between regulators and financial institutions. In such an environment many existing loopholes would be closed and the level of uncertainty would be significantly reduced.

As noted, the underlying research aim has been to offer new, critical insights for understanding the rise, the structure and the processes of the global securities market. This can be done only if the particular phenomenon is located within a broader social and political context, so that the complexity of the whole and of its parts can be comprehended. The International Relations' approach to the global environment seems particularly useful in this respect. Such an approach includes analyses of political actors, structures and processes being developed within and between different sectors of the world polity, i.e. of the global environment. Regarding the basic assumptions and theoretical findings, four main approaches to the study of international relations can be identified. They are conventionally labelled as Realism, Structuralism, Functionalism and Globalism. Instead of summarizing these approaches, some of the arguments against the first three of them will be presented. These points will, at the same time, serve to justify the theoretical orientation taken in the analysis.

The state (or more precisely, the government) is indisputably neither the only actor in international relations, nor a single, homogeneous political actor. It also does not enjoy full autonomy in defining and pursuing "national objectives", most

important of them being related to military security. The environment is not in total anarchy, and there are not just conflicts in traditional international diplomatic relations. The existence of non-governmental actors does not ultimately rest upon the power and the interests of states. In some situations, the contrary may apply: the power and interests of governments may rest upon the ability or inability to influence non-governmental actors.

From another stand-point, economic determinism is not the only factor to shape decisions and relations at all levels. There is not a general and ever-lasting unity of interests within the same classes in different countries. By the same token, interactions in international relations are not solely based on contradictory interests of different classes.

Yet from another perspective, common welfare cannot be considered as a primary goal of international actors. Although state borders are easily overcome today, they still exist and present a lasting obstacle to the rise of a global, functional organization. Although cross-border cooperation is being developed in many fields and through many forms in international relations, conflicts still exist.

Then, what does the real world of today look alike? Oversimplifying, it is a multicentric global structure, with numerous, differing participants, issues and processes that are very closely intertwined. It features complex interdependence due to: 1) an ever-growing importance of reciprocal effects among actors in international relations; 2) the existence of numerous and diversified channels among units and actors; 3) the absence of a fixed, hierarchical ordering of political questions; 4) a shift in the concept of power and the real basis of power, from the control over (military) resources to the control over economic resources, technology, information and analytical skills; 5) the emergence of various cross-border relations away from the control of governments, and the related proliferation of transnational actors; and 6) the rise of transgovernmental relations between government agencies and departments from different countries.

Having all these particularities in mind, the issue-based paradigm has been chosen as the only appropriate framework to analyze the inputs, the structures and the outputs from political processes at the global level. The concept of issues aims at surmounting: a) concrete, power-related simplifications of Realism; b) deterministic, polarizing simplifications on economic grounds, of Structuralism, and c) idealistic, conflict-ignoring simplifications of Functionalism. The issue-based approach to international relations emphasizes groups as political actors (versus states as major political actors) and the system of values (not power) as underlying grounds for political actions. So, a group of people enters a political process when it perceives certain questions as being relevant for the realisation of its goals and the values underlying them. They interact with other groups in order to mobilise support that would uphold their position in relation to the question. The contention among actors occurs over more or less concrete stakes, regarded as being instrumental for

achieving, protecting or promoting abstract values. Therefore, axiological links are the most important element in the process of grouping the stakes into issues, which are then further clustered into issue-dimensions. At the highest analytical level, there is a hyper-issue consisting of a set of such dimensions.

Applied to this analysis, all political choices affecting the construction and maintenance of a market economy (as opposed to a socialist command economy) can be regarded as a hyper-issue. That particular ideological framework links the issues from various dimensions: efficiency (the value of wealth), stability (the value of order), openness (the value of freedom), and probably the development dimension (which combines the values of wealth and international equality). It is still a matter of theoretical dispute whether the last dimension is a separate one, or is already "included" in the other three dimensions, but the inclusion of the value of equality in North-South relations seems to make it a distinct dimension. Concerning global securities flows, the most critical issues include the ones of international control, liberalization of financial markets and market integrity. The issue of international v. national control consists of a number of stakes, such as the mode, scope and object of control.

An issue comprises a set of political stakes linked by the value, while a policy contains a set of answers to a series of political questions which are functionally related. Similarly, an issue-system presents a set of actors, a set of stakes (linked by the value) and a process of interaction among the actors about the stakes. When the actors contend over proposals for the simultaneous disposition of stakes from value-linked issues, there exists a wider issue-system. For example, a wider issue-system for maintaining stability of global economic flows includes the following issues: international v. national control, macroeconomic coordination v. competition, international lending (for balance-of-payments purposes), and money laundering. A wider issue-system for improving global economic efficiency consists of issues such as the market integrity, transfer of technology, trade v. direct investment, etc. These issues are perceived as being on the same issue-dimension, i.e. relevant for the realisation of values of order and security, in the first case, and relevant for the value of wealth in the second.

When it comes to taking decisions on issues and stakes, functional, bargaining and actor linkages create policy-systems. So, a wider policy-system encompasses related policies, when the actors contend over proposals for simultaneous disposition of stakes from these policies. In financial markets the policy systems are mainly formed by functional links rather than bargaining or actor linkages. For example, there is a wider policy-system for global capital flows, cutting across several wider issue-systems and including several policies such as: liberalization, international control and supervision, efficiency promotion of transnational operations, prevention of money laundering, etc. Stakes, like for example entry requirements, data reporting, standardisation of market procedures,

are interrelated to such an extent that their disposition must be negotiated within a broader context. This has to be done simultaneously even though the stakes belong to different issues, and even lie on the different issue-dimensions. Actors perceive certain stakes and issues (or groups of stakes and issues) as being related to certain values, whose satisfaction they aspire to protect or improve. However, perceptual concepts may differ from actual concepts of dealing with such issues, due to the existence of a variety of actors and possible linkages that can be created among issues.

It has been widely accepted that the phenomenon of cross-border capital flows is not just a truly global problem but rather a part of an even wider phenomenon of a rising global market economy. However, it has not been possible to design a global mechanism to handle such flows. In the International Relations' language, it has not been possible to achieve a final disposition of stakes, and the last part of this conclusion will examine to what extent an interim allocation has been achieved. Two groups of reasons, *inter alia*, have accounted for this. Firstly, certain postulates (institutions in a broader sense) of the "classical" concept of the market economy have become increasingly inadequate. For example, the domain and mechanism of government economic policy, government economic "sovereignty", its autonomy and rational decision-making, and existing intergovernmental organizations in the sphere of money and banking have all failed to adapt adequately to the effects of globalisation.

Secondly, the problem of globalized capital flows has proved to be rather complex in nature. It should be viewed as related to domestic and cross-border trade in both goods and services (and also the illegal trade in arms and drugs), interest and exchange rate policies, technological and industrial policies, environmental policy, etc. There is neither one single government nor an intergovernmental organization capable of creating an arrangement (a broad policy) for global capital flows. Upon these grounds, it can be concluded that the global capital market has "outgrown" the status of an economic problem and has evolved as a political one. A result has been the emergence of a wider policy-system, encompassing several functionally related policies, many different actors, a number of issues and stakes to be allocated.

Following this research, the analysis has shifted to political actors and processes in order to offer answers to a set of questions: 1) which are the political actors most deeply involved in the debate over the global capital flows; 2) how do they perceive the issues, and what attitudes and routes to the agenda do they take; 3) how do certain political stakes become grouped together and how do particular policy-systems emerge, and 4) what kind of relations and structures exists among these actors.

The world of today features a great diversity and multiplicity of political actors. In this particular case, that diversity ranges from individual banks and local

banking associations, through various international organizations and associations, to universal organizations such as the United Nations.<sup>6</sup> The actors have been categorised (just for analytical purposes) into four groups: banks and dealers, international non-government organizations, national authorities and intergovernmental organizations. In spite of the analytical categorization, strict demarcation lines between them have proved useless and theoretically unjustifiable. Attitudes and postures of an actor cannot be ex ante defined, just according to its name, status or origin. The same applies for the values one may expect them to strive to enhance. It is not always the case that banks are solely interested in promoting freedom to operate, efficiency or the value of wealth. By the same token, government regulators may well consider the values of order and safety as subsidiary to over-all efficiency.

The ranking of values that underlies political actions varies across actors and time. Although banks and their associations primarily accentuate values such as freedom and wealth, they indeed recognize that order must be maintained at all levels of functioning. National regulators and their "organizations" still predominantly stress the values of order and safety. Even so, they have come to accept the fact that the pursuit of these values is meaningless if it adversely affects over-all market functioning and efficiency. So, both "sides" have entered the political process bearing in mind that a compromise has to be reached at the intersection of their aspirations.

There is a great diversity of actors, both within and among the groups. Two developments have to be underscored in this respect. Financial institutions of today have grown well beyond their "classical" intermediation functions. Banks have developed transnationally not just to be able to execute orders and underwrite securities worldwide - modern banks persistently (and successfully) endeavour to shape the environment by using the political system. They often feature a high sense of political efficacy. Secondly, regulators have realized that the maintenance of close contacts with the business community is a prerequisite for efficient regulation. Moreover, contacts must be established and nurtured also with professional associations in other countries, as well as with international non-governmental organizations.

The multiplicity of channels through which an actor can contend over political questions emphasizes an unacknowledged (but highly sophisticated) global network of communication and debate. The frequency with which most of the actors communicate (internally and externally) adds to this global market a new quality: a very lively, world-wide political interplay. As the market continuously advances, the issues come to rank higher and higher on the political agenda of many actors.

The interplay of political forces have been centred around four issues:

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<sup>6</sup> A survey of major actors and their preferences is presented in the Appendix.

international control, capital rules, liberalization and market standards. Nevertheless, it is difficult to conclude whether there is one global agenda, or these issues are placed on different international agendas. Due to very strong functional linkages between the issues, one would have expected that there would be a single, world-level agenda where most of the critical stakes in relation to capital flows are debated. Until the end of 1992, none of the issues has reached the final decision-making stage, and it is disputable whether they have entered even the ritualization phase. However, after a careful and detailed comparison of the advance made on each of the issues, it is possible to summarize a group of basic beliefs that underlie these political processes. If this is taken as a body of principles and norms to govern actors' behaviour, one can assume that there are certain conditions for a broad framework for global capital flows to emerge.

Basic values sought to be protected are wealth, order, freedom and development. National regulators, for example, usually perceive the global integration of capital flows as threatening the basic value of order; most banks see that phenomenon as opening new opportunities for an enhanced satisfaction of the values of freedom and equality; international governmental organizations consider it mainly as one of the alternatives for improving the overall economic efficiency (the value of wealth). It is possible to outline several basic principles, agreed upon by the great majority of the involved actors.

Firstly, national authorities should fully cooperate in supervision of transnational banking. This can be further elaborated through a set of norms, such as: 1) no transnational activity should be allowed to escape supervision; 2) such supervision should be carried out on a consolidated basis, so as to provide control of the whole of a transnational bank; 3) cooperation among national authorities should be as extensive as permitted by the limits of national laws and public policy; 4) international regulation should not impose excessive burden on market participants, and thus adversely affect market efficiency.

Secondly, market stability is crucially influenced by the level of soundness of transnational banks. For the protection of the values of order and security, international regulation should develop a set of widely-accepted standards for assessing the financial strength of banks. Possible norms which should guide desirable behaviour may be: 1) financial institutions should maintain adequate capital against their operations; and 2) the adequacy of capital should correspond to different risks inherent in transnational financial operations.

Thirdly, protectionism can greatly reduce overall economic benefits, so the national markets should be maintained open. This widely-accepted general orientation needs further clarification, and hence a set of norms, such as the following: 1) banks should have the freedom of establishment and operation; 2) there should be no discrimination between domestic and foreign banks; 3) countries should be allowed to limit the level of market openness under certain, well defined

conditions, and 4) the achieved level of global openness should not be decreased.

Fourthly, efficiency of the market is primarily determined by adequate business conduct of transnational banks. So, in order to protect the value of wealth, the behaviour of all actors should be guided by the following norms: 1) in carrying out their financial operations, banks should comply with the highest ethical standards; 2) an adequate level of market transparency should be maintained; and 3) investors should be granted appropriate protection from derogation of the two previous norms.

If the findings from the second part of the analysis are integrated, one can consider them as the elements for sketching a "political portrayal" of the global capital market, as a complement to its "economic portrayal" presented in the first part. Let us now examine, step by step, the situation from the aspect of regime theory.

As explained, the reach and the extent of the global integration of capital flows accentuate the need for coordination and cooperation. This is not just related to cooperation among national regulators, but also among and between all other actors on the scene. In this case, the prime motive has been a two-fold one. On one hand, there are common aversions, most notably a desire to prevent a particular outcome: the breakdown of the global system of capital flows. On the other hand, there are common interests, the most important being related to improvement in market efficiency. A new quality arises as a result of the fact that the need to cooperate has not been related to either of the two purposes, but to the both of them simultaneously. It can be concluded that the globalization of capital flows has created a collective situation requiring collective action to achieve joint gains and to avoid joint losses. Such a dual nature of the need to cooperate derives from extensive functional (and other) linkages between the issues concerned.

Though a mere acknowledgement that a collective situation exists is indeed an important condition, it is exceptionally far from being practically sufficient. What has to bridge the distance between such a shared perception and a desired outcome is a more or less elaborated structure, or "rules of the game". This intervening structure should guide the behaviour in accordance with common beliefs, agreed standards and practices, thus reducing uncertainty and increasing the probability of a desired outcome.

Concerning regime formation, one can (and should) here integrate economic, political and cognitive explanations. Economic changes that had greatly contributed to the need for a regime are: internationalization of domestic capital markets; proliferation of various external markets; technological advances; economic restructuring of industrialized, ex-socialist, as well as developing countries; and a growing sensitivity and interdependence of interest rate and exchange rate movements. It can be also argued that the power-basis has shifted from the control over resources to the control over outcomes. For example, the US government

indisputably controls the largest pool of economic, military and technological resources in the world. Even so, it has not been able to exercise a sufficient degree of control over the creation of a particular segment of the global financial market - the Eurodollar market. Actually, not a single actor (international or national, governmental or non-governmental) can exercise control over today's financial "outcomes", i.e. over the global integration of capital flows. This is exactly why there is a strong need for a regime to be designed.

Situational mode explanations can add another perspective on this need: the actors indeed have to make choices between incompatible alternatives, each having both desirable and undesirable consequences. For example, the issue of liberalization v. protectionism of financial markets most clearly involves such alternatives. A government cannot expect the national economy to benefit, at the same time, from an increased competition and a controlled development of the financial sector. As actions of one actor can produce significant adverse effects upon the others, collective action seems to be the only acceptable form of response to the collective situation.

In relation to regime purposes, it is evident that a global arrangement for capital flows would primarily aim at reducing risk and uncertainty. From the theoretical point of view, this comes as a primary purpose when there are serious disruptions (or inefficiencies) in basic functions that the market has to perform. As explained, if a market has to bridge various gaps between supply and demand (the intertemporal, the interlocative and the interpersonal gap), the flow of information and knowledge about the environmental determinants is absolutely crucial. For example, if the global securities market has to provide the best possible method of raising capital (or a combination of different, geographically dispersed sources), financial intermediaries have to be certain that national regulators would not suddenly restrict their operations in the markets concerned. The very same applies, for example, to the market integrity issue: market participants have to be confident that their counterparts would adhere to the same norms of business conduct if the transactions are to be completed successfully, i.e. if the market is to perform the function of closing the interpersonal gap.

Throughout the literature, various conditions have been suggested as being necessary, adequate or sufficient for regime creation. In this particular case, it is obvious that there is a high degree of politicization, and policy making in one polity affects and is affected by that same processes in other polities. For example, the OECD policy towards restricting the use of the reciprocity principle has been seriously affected by the adoption of the Second EC Banking Directive. Therefore, collective action is needed to reach a disposition of stakes within the liberalization issue. Domestic policies are, on one hand, very closely linked to those of other polities (for example, changes in interest and/or exchange rates). On the other hand, not one of them could have achieved a sustainable level of command over the global

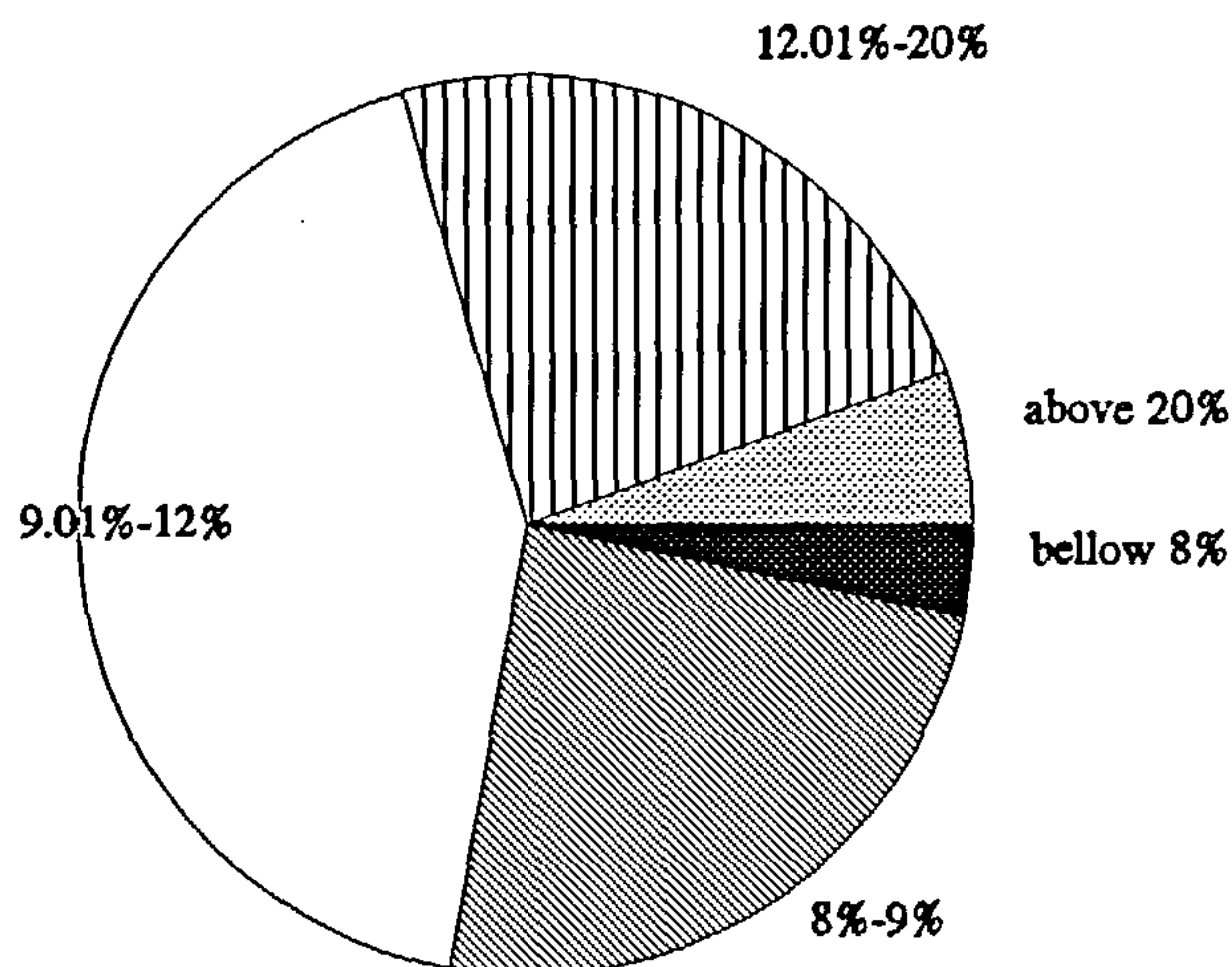


capital environment. That is an additional condition for regime creation. Furthermore, as there is a number of critical, important issues within the policy-domain, actors have come to realize that (in general) the benefits from a widely-agreed arrangement would be higher than the costs of surrendering a certain degree of "absolutely" independent decision-making.

However, particular modes through which this "surrender" will be carried out have not yet been framed. To put it differently, a set of concrete policy norms and an organization to implement them still wait to be agreed upon. Egoistic self-interest and a regime-conducive policy for most actors (not just governments) are present, as two among the basic variables to cause regime formation. Nevertheless, there is a clear lack of a widely accepted and shared knowledge in relation to particular aspects of the functioning of the global market. For example, the US regulators generally do not accept postulates of portfolio diversification theory, that have been praised both by countries with a liberal banking tradition and by non-governmental actors. Closely related to this, norms and principles indirectly linked to the issues (for example, those related to basic axioms of economic governance or of maintaining order) differ to an extent that any compromise would require weighty concessions on all sides. In addition, there is no practice or regular pattern of behaviour from past practice which can be turned to, as the phenomenon of the linking of world-wide capital is of a recent origin.

In spite of that, significant progress has been achieved in relation to two stakes: the object of international control, and the ways such control should be performed. A set of widely-accepted standards have been agreed for assessing the financial soundness of transnational banks, mostly resembling the Basle capital rules, to which many countries adhere to. The pressure to meet the rules has had a number of effects.

Figure 1: BIS Capital Ratio in 1993  
(reported by 339 banks)



Many banks have turned to ingenious ways of raising new funds, for example by issuing undated preference shares that count for capital, or by using their customer base to cross-sell other products. The standards have focused on the need to maintain or improve profitability. Interest margins have been improved, particularly on international lending business. The top twenty US banks, for example, increased margins by 15 percent in the period from 1990 to 1992.<sup>351</sup> Costs have been cut, either by cutting dividends and reducing the number of branches, or by merging with rivals. The 1993 survey of the top one thousand banks, conducted by "The Banker"<sup>352</sup>, clearly pointed that the Basle capital standards have been followed by a great number of banks. More than one-third of the group reported the ratio, and of that only a small number has failed to meet the BIS capital ratio of 8 percent. Figure 1 gives more details about the soundness of the reporting banks.

What has to be highlighted, however, is a different attitude taken by the most influential banks in relation to their capital strength. American banks have made the most successful efforts to boost the capital base and in that way regain the confidence of investors world-wide. Leading UK banks have been successful to a similar extent, while Japanese banks have just managed to cross the line of eight percent.<sup>353</sup> Nevertheless, it can be concluded that the BIS standards have been accepted by those most important and most influential banks: all of the top 136 banks have their capital/asset ratio above the required level.

In addition to the capital requirements, transnational banks should be subject to a coordinated supervision of home and host countries, on a consolidated basis. However, in both cases, there is still plenty of room for derogation from these basic norms. National regulators can indeed design and apply rules stricter than those internationally agreed, and they can claim the right to withhold from cooperation with other countries on "public policy grounds", i.e. if certain national objectives from the sphere of the so-called "high politics" are in jeopardy.

A certain degree of progress (from the theoretical standpoint) has also been accomplished in respect of institutionalization: several organizations have placed themselves at the very top of the political structure wherein bargaining occurs. Some of them are governmental and some non-governmental, some of them are national and some are international. Though a lack of a single institution to administer a regime is usually seen as an obstacle for its effective application, in this specific situation it may well be the opposite. A particular "mixture" of various types of political actors that dominate the debate (national securities regulators, banking and stock exchange associations, committees of international organizations, central bankers and international groups of regulators) highlights the complex nature of the phenomenon. It also underscores the complementary character of the two most critical objectives: efficiency and stability. While one can assume that a transnational (non-governmental) regime for global capital flows does already exist (for example,

within the framework of the International Securities Market Association), creation of an intergovernmental regime for such flows faces today two alternatives. On one hand, it can be designed as a rather loose arrangement to allow substantial discretionary powers of national regulators, thus failing to reduce overall uncertainty and systemic risk. On the other hand, the ongoing political bargaining over more concrete norms and rules could unduly prolong the process and even lead to a stalemate, which would definitely allow for an increase in regulatory competition, uncertainty and systemic risk. Having in mind a high degree of global economic interdependence, both alternatives seem deficient. Nevertheless, the composition of the most influential actors on the scene could point to a third alternative.

As suggested in Chapter Five, world complexity can be viewed as consisting of two worlds: the intergovernmental world and the multi-centric world. It is the structure and processes of the latter that created the conditions for a transnational regime for capital flows to emerge. The whole first part of this analysis can be understood as describing such a regime, i.e. the global capital market with its origins, organisation and mechanisms. Moreover, two particular institutions (the International Securities Market Association, ISMA, and the International Federation of Stock Exchanges) have established themselves as focal points for elaborating the rules and decision-making procedures in relation to conduct of capital transactions. What is most important is that, at least until now, the regime has proved to be operational. Let us now examine, in more detail, "rules of the game" created by ISMA.

Although the International Securities Market Association was included in the survey of the main political actors (Chapter Six), few remarks on its scope and size are due here as well. It was founded in 1969, at the time of the Euromarkets' explosion. Since then it has grown to encompass more than nine hundred banks and securities houses. In 1991, a total turnover in secondary trading by ISMA members amounted to nine trillion US dollars (equivalent)<sup>354</sup>. The successful functioning of this global arrangement for capital flows definitely derives from an elaborated structure of norms and rules created by ISMA. Bearing in mind regime theory, any arrangement has to be based on a certain body of principles, norms, rules and decision-making procedures, in order to become operational. In the case of ISMA, these elements are clearly defined and structured in a consistent way, so that the basic values are protected.

As described in Chapter Six, the basic values that guide all actions of the Association are freedom, wealth and order. Therefore, the basic principles can be defined as follows. Firstly, the key objective of any arrangement for global capital flows is the improvement of efficiency of economic system, be it a national system or the global economy. Secondly, an adequate degree of order must be maintained on the global capital market if such positive effects are to be generated.

A set of norms has been developed on this basis. The global capital market

is to be kept transparent and liquid to the greatest possible extent. The Association and its members establish and maintain regular contacts with securities regulators, in order to exchange information and improve cooperation among all classes of regulators: self-regulatory organizations, statutory regulators, and intergovernmental statutory regulators (e.g. the EC Commission). Regulation of securities markets has to be designed so as to avoid adverse effects on market efficiency, and it has to contribute towards a reduction of costs to the consumer (not vice versa). Moreover, it has to resemble the most important peculiarities of the global capital market, with regard to its different segments and levels of functioning. For example, rules for wholesale and retail investment banking, as well as for domestic, international and global banking, do not necessarily have to be the same.

One of the most significant features of the ISMA regime is a comprehensive "package" of detailed rules for all aspects of its functioning, specifying members' rights and obligations. For example, members of the Association must comply with just and equitable principles of business, observe good market practice and apply the highest standards of professional integrity to all business dealings. The Association is open to banks, members of recognized stock exchanges and licensed securities dealers, which can become full members. In addition, organizations which are neither banks nor dealers may become associate members in the case they have an important role in the market and maintain close relations with ISMA. Associate members have no right to vote or to take part in elections, but nevertheless actively participate in discussions.

Transactions in international securities (Euro-securities) are organized according to several groups of rules, each covering different phases of the business: matching of supply and demand, reporting of completed transactions, reporting of closing bid and offer prices, confirmation of trades, settlement procedures, and reporting a list of securities prepared for the following-week trading. The "core" members of the Association, the reporting dealers, have even wider obligations: they have to subscribe to TRAX, i.e. to the ISMA's computer network for matching transactions in securities<sup>355</sup>, and they have to make a two-way price for a determined "structure" of securities (with respect to the currency of denomination, the trading sizes and trading hours).

Disciplinary rules cover all situations when there is an alleged or actual breach of the ISMA's statutes, by-laws and rules. Apart from the event when there is a breach of any rule, disciplinary actions may be taken and sanctions imposed if there is evidence about a member's misconduct causing substantial damage to the interests of the Association. In any case, misconduct is sanctioned by reprimands, fines, suspension or loss of membership.

Concerning the key objectives of maintaining an efficient and orderly market, ISMA members do indeed have diverse obligations. At the same time, they have certain rights that enable them to exercise significant influence on the regime

structure and the market functioning. For example, the Market Practices Committee proposes and revises uniform market standards, but a body that actually formulates new rules and amends the existing ones is the Committee of Reporting Dealers. So, the members that are in fact the most responsible for market liquidity and transparency - reporting dealers - have the strongest impact in creating the regime rules. In addition to discussions on general meetings, members have the right to bring certain problems, directly related to a particular geographical region, to the agenda of a corresponding Regional Committee. Both perspectives, the functional and the geographical, are taken into consideration when the regime rules and procedures are creating or changing. For example, when the Board has to be elected

"... the selection of candidates must reflect a balanced representation in the board of the geographic composition of the Association and the current importance in the international securities markets of particular regions or areas, and the various functions in the markets."<sup>356</sup>

In addition to the principles, norms and rules, appropriate decision-making procedures have been created, in relation to, for example, changing of the trading rules, conciliation and arbitration, constitution of a disciplinary tribunal, etc.

ISMA has joined a number of international quasi-non-governmental organizations, in order to maintain close contacts with both regulators and other trading associations. So, ISMA could indeed be considered as an example of a global, non-governmental regime for capital flows. Nevertheless, this may not lead to a conclusion that it has been totally independent of the intergovernmental world.

"Since whole systems and subsystems can be actors in both worlds - with states being drawn ever further into the multicentric world by an intensified interest in expanding their share of world markets and with other actors being drawn into the state-centric [intergovernmental] world by virtue of their physical presence on the territories of states - the overlap between the two worlds is inherent in the structure of the global system."<sup>7</sup>

The links between the two worlds and efforts (or needs) to resolve clashes between them may well indicate the future course of international relations development. By mutual accommodation and acceptance of the legitimacy of the other world, conditions could be created for a global securities regime to emerge. A process through which such a special amalgamation of the transnational and an intergovernmental (inter-state) regime for capital flows would apparently resemble the Global Politics model. This is a challenge regime theory cannot escape facing.

The ultimate aim of this analysis has not been to offer any definite explanations, but rather to suggest alternative research courses in both economics and politics. As in any other social research, the passage of time will reveal to what

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<sup>7</sup> ROSENAU, J. N. (1990): "Turbulence in World Politics" (Princeton, N. J.: Princeton University Press), p. 271-272.

extent such aspirations are justified in reality. However, several particular developments on the global economic scene have to be mentioned here, as they occurred after the empirical part of this research had been completed.

During 1992 and the beginning of 1993, the global capital market witnessed certain changes with respect to its structure and functions. These changes have not been so dramatic as at particular times during the 1980s, but have nonetheless pointed to new developments which could significantly influence the market's future. Although a rapid growth of the world's derivative markets has begun in the latter part of 1989, they profoundly increased during 1992. All derivative instruments have gained in attractiveness, traded both on exchanges and over-the-counter.<sup>357</sup> At the end of 1992, the value of on-exchange derivatives amounted to 4.5 trillion dollars, and the stock of over-the-counter derivatives was worth another 4.5 trillion dollars.<sup>358</sup> Concerning the structure of traded instruments, interest-rate futures and interest-rate swaps dominate over other derivatives. One of the reasons accounting this is undoubtedly a lack of confidence in signals of economic recovery in industrialized countries.<sup>359</sup>

A new trading system for futures and options, Globex, was launched in June 1992<sup>8</sup>. As it is the international after-hours screen trading system, it is expected to attract new customers by reducing barriers like time-zone differentials and lack of familiarity with different markets. At present, Globex links trades on the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Exchanges and the Matif (Paris). The main instruments traded within this global network are futures and options on currencies, the Eurodollar contracts and 30-year Treasury and Libor contracts.<sup>360</sup> Giving an investor the access to 60-70 percent of the world's futures trading, Globex will add to the already intensifying competition among European exchanges.

In addition to derivatives, global equity issues have also begun to attract more attention. In 1992, for example, the total value of equities issued simultaneously in a number of markets was around 25 billion dollars, which was more than double the figure for 1988.<sup>361</sup> Different factors have generated this expansion, including a push towards privatisation in many industrialized countries, a growing inability of domestic markets to meet financial needs of global companies, and a trend towards increasing portfolio diversification of large investors. What is most important is that American investors and investment banks have again come to dominate this market segment, reversing the trend of "buying-out America".<sup>362</sup> Moreover, there are not just large institutional investors that tap the global equity market. Giant transnational industrial companies have also discovered many benefits of global issues. For example, the world's largest consumer electronics producer,

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<sup>8</sup> Globex was included in the survey of computer networking in banking in Chapter Two, section five.

"Matsushita Electric Industrial", launched a global bond offering of one billion dollars in July 1992. The issue was the first such offering by a private company, launched on US and European markets simultaneously.<sup>363</sup>

Changes are also occurring in relation to the relative position of the main financial centres. In order to promote competitiveness of German markets, eight stock exchanges were brought under a single holding company "Deutsche Borse" in the beginning of 1993. Reserve requirements for German banks were cut and new short-term government securities introduced to strengthen the concept of "Finanzplatz Deutschland".<sup>364</sup> Nevertheless, the gap between London, on the one hand, and other European centres, on the other hand, has not been declining. It was estimated that the London exchange handles around 95 percent of all European cross-border share trading.<sup>365</sup> In response, bilateral and multilateral links have been developed among continental exchanges (e.g. between the Matif in Paris and the Deutsche Terminbourse). At the other side of the world, Japanese financial markets have been slowly recovering from a disastrous beginning of the 1990s. Nevertheless, the stock market turnover in 1992 was only one-third of the turnover in 1987 or 1988.<sup>366</sup>

Concerning the developments in regulatory sphere, not much progress has been achieved in the negotiations over the IOSCO capital standards for investment banks. After three years of negotiations, the gulf between the US SEC and other securities regulators is wider than ever. The US regulator wants an investment bank to maintain a high minimum capital level (in accordance with the domestic rules), while the SIB and the others prefer different standards that would encourage investment banks to use netting techniques to hedge their portfolios and reduce the risks. Regarding the supervision of financial conglomerates, IOSCO's standards were published in October 1992, allowing for the full spectrum of supervision techniques. In contrast to Basle standards, they do not propose any routine exchange of information between home and host regulators.

The Uruguay Round of negotiation to extend the coverage of the General Agreement on Tariffs and Trade was completed in December 1993. Contrary to some predictions, it did not result in the creation of a global regime for services, though certain services (e.g. those related to trade aspects of intellectual property rights and direct investment) found their place in the draft agreement. However, the expected agreement on liberalization of financial services was not reached, and the appendix for financial services in the draft agreement was left empty. At the beginning of 1994, one can only speculate about reasons for which financial services were left out. Nevertheless, two possible causes come to mind. Firstly, as financial services (and the financial sectors, in general) today generate an immense and critical effect on the national economy, liberalization of them "strikes at the core of national systems of economic management and state decision-making" (G. Underhill, 1993, p. 118). Once reached, such a general agreement on services would inevitably

contribute to a further internationalization of economic decision-making, i.e. it would require governments to "surrender" an additional degree of their "sovereign" economic management. Secondly, it would probably affect the relationship between governments and their "domestic" service sectors, especially in economies where the financial sector is heavily regulated. For example, US banks were the first to lobby for liberalization of financial services. Even so, they have realized that, under the current regulatory conditions in the US, a global agreement on liberalization would just fortify already-existing competitive advantages of foreign banks in the US.<sup>367</sup>

The rapid expansion of derivative markets has also generated new regulatory proposals from the Basle Committee. In addition to the development of techniques for assessing market risk, debt and equity derivatives, as well as currency futures and swaps, have been included in the framework.<sup>368</sup> It is expected that the Committee will issue a formal amendment to the 1988 Capital Accord, to be implemented from the beginning of 1997 at the earliest. Another important aspect of regulatory changes can be found in the Introduction to the 1993 proposal:

"The very fact of this extraordinarily rapid pace of change underscores the Committee's belief that the time has come to solicit the views of market participants... The Committee is keen to develop an international agreement which would apply to all major market players. However, because the consultative process will, of necessity, be long and the phased implementation even longer, it is the Committee's judgement that its internal deliberation cannot proceed further without the benefits of market participants' reactions to the overall approach."<sup>369</sup>

A closer touch with market participants and a greater reliance on market mechanisms were also highlighted by Mr Richard Breeden, chairman of the US SEC. In explaining why there is no safety net for the US securities industry, he put forward that

"... market disciplines are stronger and more omnipresent than any number of rule-setting bureaucrats and bank examiners. Markets don't go to sleep."<sup>370</sup>

Although SEC advocates high capital requirements for investment banks, Mr Breeden's statement clearly points to a significant digression from the "anxiety approach" (over-regulation in banking). On the other hand, the "confidence approach" has come under a challenge in the country of its origin - in the UK. In May 1993, the Securities and Investment Board was considering a new central, computer facility to centralize information about many different types of transactions in individual securities and derivatives, in order to combat fraud and market-manipulations. At the same time, Mr Andrew Large, the chairman of the Board, submitted a proposal for strengthening the SIB's role in setting standards of regulation.<sup>371</sup> In spite of the long-standing confidence in banking in the UK, one of the self-regulatory organizations (the Securities and Futures Authority) has



recently banned a dealer indefinitely from the securities business for taking excessive risk and incurring a heavy loss for his firm.<sup>372</sup>

As pointed earlier, the creation of an intergovernmental regime for capital flows faces many obstacles and negotiations are slowly advancing. Meanwhile, some regulators have found it more efficient to take a gradual, "similarity of standards" approach to securities regulation (instead of striving for the full convergence). The most important example is the inauguration, in July 1991, of the Multi-Jurisdictional Disclosure System (MJDS) between the securities commissions in Toronto and Washington. Companies have been allowed to raise equity funds cross-border as long as they follow the disclosure standards in either of the countries.<sup>373</sup> As a final disposition of stakes seems unattainable in the near future, this kind of development may offer a solution for the present stalemate.

The purpose of including some of the most recent developments was to lay the grounds for offering an outline of future research. The dilemma "supervision or regulation" will definitely be the most critical issue in relation to the global economy, bringing to the surface some of the most significant contrasts in various types of orderly market economy. Directly related to this, the concept of consolidated financial supervision will, sooner or later, generate a hot political question of each country's supervisory credentials. In the case when both home and host regulators will have to be confident in regulatory competence of the other, it is unclear what will be the criteria to evaluate such capabilities.

Regulation of derivative markets is another field where different ranking of values will be most clearly contrasted. On the one hand, it can be argued that such instruments have been designed to reduce risk, so, besides contributing to efficiency, they improve market stability. On the other hand, this development has been criticized as being too "detached" from both the real economy and the traditional market functioning. From this aspect, markets have become less transparent and more difficult to supervise. So, even though they might contribute to efficiency, a threat they pose to the values of order and stability is seen as more dangerous.

Finally, functional linkages in the policy-system for global capital flows will undoubtedly modify the existing issues and probably add some new ones. The trend towards closer economic integration, as exemplified by the transformation of EC into European Union and by the NAFTA Agreement, is not expected to foster significantly the coming of a truly global economy in a near future. However, a number of interim solutions reached in such regional integration processes can be understood as modifying, for example, the issue of liberalization. Instead of being within the realm of national economic policy, the level of market openness has increasingly been assessed from a new perspective: order vs efficiency of region as a whole. Other functional linkages in relation to, for example, market reforms in former socialist countries, international efforts to prevent money laundering or financial sanctions against Iraq and Yugoslavia, will also add to the political

complexity that surrounds the global capital market.

As evident, it has always been difficult to speculate about the evolution of modern financial markets. This certainly applies to both economics and politics of the global capital market. Regime theory can indeed provide a useful concept for coping with such dynamics and complexity. Nevertheless, it must not resist changes within the concept itself, keeping in mind that walls between the intergovernmental world and the multi-centric world are falling down with every bond and equity issued.

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9. The concept origins can be found in: ORGANSKI, A. F. K. and J. KUGLER (1980): "The War Ledger" (Chicago: University of Chicago Press).
10. SNIDER, L. W. op. cit., p. 1263.
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12. EL-ERIAN, M. A. "Voluntary Market Financing", in FINANCE AND DEVELOPMENT, March 1992, p. 38.
13. For example, the GNP deflator averaged 7.1 percent for G-7 in the period 1968-77. In 1979, it rose to 8.2 percent and further to 9.3 percent in 1980. Detail data on the worldwide economic conditions in the period can be found in: INTERNATIONAL MONETARY FUND (1986): "Annual Report".
14. KRUEGER, A. O., op. cit.
15. INTERNATIONAL MONETARY FUND (1986), "Annual Report", p. 42.
16. HELLER, H. R. "Debt and the Future of Bank Lending", in: ECONOMIC IMPACT, 1987/4, p. 21.
17. IMF (1990): "International capital markets", p. 37.

18. Debt-equity swaps imply the conversion of a portion of the debt into equity holdings or other assets in new or existing entities in the debtor country. Exit bonds are conversions of the old claims, issued at the discount, with fixed interest rate and the principal collateralised by US Treasury zero-coupon bonds.
19. It included debt-equity conversion, interest-rate reduction and principal-reduction bonds. Also, it incorporated the trade financing arrangements and onlending facilities, as well as the value-recovery clause, which allowed banks to receive extra payments in the case if the price of Mexico's oil exceeds an agreed level.
20. In 1980, capital of US banks was just over 5 percent of their total assets; in 1989, the ratio was 8.4 percent. External claims on developing countries equalled 10 percent of their total assets in 1980; nine years later, it was reduced to about 5 percent. In the period 1980-1989, the "coverage" of capital to external claims on developing countries was improved from 53 percent to over 170 percent. (Source: IMF [1990], p. 39.)
21. The disaster myopia is an attitude towards safeguarding and defensive strategy (particularly in business): the longer the time since the last disaster (collapse, major disturbances or alike), the less attention being paid to cautionary measures.
22. A survey of recent actions taken by the Paris Club can be found in: KLEIN, T.: "Innovations in Debt Relief: The Paris Club", in: FINANCE AND DEVELOPMENT, March 1992.
23. For more details, see: KEESING'S RECORDS OF WORLD EVENTS, Vol. 36, 1988, No. 9. p. 36185-7.
24. THE ECONOMIST, December 16, 1989.
25. An illustrative example of this can be found in: GREENWALD, B. and J. STEIN: "The Task Force Report: The Reasoning Behind the Recommendations" (Journal of Economic Perspectives, volume 2, number 3, Summer 1988).
26. TURNER, P. (1991), p. 26.
27. TURNER, P. (1991), p. 43 and 56.
28. UNITED NATIONS: "World Economic Outlook 1990", p. 17.
29. OECD: "Financial market trends", number 46, May 1990.
30. KEESING'S RECORDS OF WORLD EVENTS, Vol. 34, February 1988, p. 35740.
31. For a detail explanation see: THE PENGUIN INTERNATIONAL DICTIONARY OF FINANCE (1990), and BRIMMER, A. F.: "Distinguished Lecture on Economics in Government: Central Banking and Systemic Risks in Capital Markets", in: JOURNAL OF ECONOMIC PERSPECTIVES, Vol. 3, No. 2, Spring 1989.
32. A detailed survey of the debate over possible causes of the Crash can be found in: INTERNATIONAL BUSINESS WEEK, issues from November 2, November 9 and November 16, 1987, as well as in the issue from April 18, 1988.
33. GREENWALD, B. and STEIN, J. (1988), p. 15.
34. BIANCO, A.: "Must the panic get worse to spark reform?", in: INTERNATIONAL BUSINESS WEEK, November 9, 1987, p. 30.
35. THE BANKER, June 1984, p. 15.

36. THE BANKER, May 1982, p. 85.
37. THE BANKER, September 1982, p. 7.
38. The Bank of Italy did not consider the Luxembourg subsidiary as being "under its auspices", because it was a holding company, so it did not attempt to provide emergency financial assistance. After the bank went into liquidation, president of the Consob (the regulatory authority of the Milan stock exchange), professor Guido Rossi resigned. He complained that he was denied sufficient information by the central bank, regarding financial details about Banco Ambrosiano, so he approved a full listing of the bank's shares on the exchange. The quotation was interpreted by many shareholders, and prospective investors as well, as a certificate of creditworthiness for Banco Ambrosiano.
39. For an extensive analysis of financial risks and public policy in relation to international financial markets, see: PORTES, R. and A. K. SWOBODA (eds.) [1987]: "Threats to international financial stability" (Cambridge University Press).
40. See INDEPENDENT ON SUNDAY, July 7, 1991, and TIMES, August 9, 1991.
41. More details about Islamic banking in: "How BCCI adapted the Koran rules of banking", TIMES, August 13, 1991.
42. FINANCIAL TIMES: "BCCI: Behind Closed Doors", November 15, 1991.
43. INTERNATIONAL BUSINESS WEEK, July 22, 1991, p. 32.
44. Basic sources include: "Inquiry into the Supervision of The Bank of Credit and Commerce International" (The Bingham Report), HC (1992-93) 198, (London: HMSO, October 1992); KEESING'S RECORD OF WORLD EVENTS, News Digest for July and October 1991, and KEESING'S UK RECORD, various months in 1992.
45. AFRICA EVENTS, August 1991, p. 19.
46. House of Commons, Session 1991-92, TREASURY AND CIVIL SERVICE COMMITTEE, Fourth Report: "Banking Supervision and BCCI: International and National regulation" (HMSO, London, 1992), and House of Commons, Session 1992-93, TREASURY AND CIVIL SERVICE COMMITTEE, Second Report: "Banking Supervision and BCCI: The Implications of the Bingham Report" (HMSO, London, 1993).
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50. "Inquiry into the Supervision of The Bank of Credit and Commerce International" (see note 44), p. 181.
51. An article covering the rise and fall of Drexel can be found in: INTERNATIONAL BUSINESS WEEK, February 26, 1990.
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56. *ibid*, p. 156.
57. *ibid*, p. 160.
58. REYNOLDS, P. A. (1980): "An introduction to international relations", (London: Longman)
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60. ROSENAU, J. (1976), p. 16.
61. WILLETTS, P. : "Transactions, networks and systems", in: GROOM, A. J. R. and P. TAYLOR (eds.) [1990]: "Frameworks for International Cooperation" (London: Pinter Publishers), p. 277.
62. Besides already cited LITTLE and SMITH (eds) [1991], other sources for comparing different labels include: BANKS, M. "The Inter-Paradigm Debate", in: LIGHT, M. and A. J. R. GROOM (eds.) [1985] "International Relations. A Handbook of Current Theory" (London: Frances Pinter); SMITH, M. et al. (eds.) [1981]: "Perspectives on World Politics", Open University, (London: Croom Helm); MAGHROORI, R. and B. RAMBERG (eds.) [1982]: "Globalism Versus Realism: International Relations' Third Debate", (Boulder: Westview Press).
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68. See K. W. DEUTSCH (1953): "Nationalism and Social Communication" (Cambridge: MIT Press); KEOHANE, R. O. (1984): "After Hegemony: Cooperation and Discord in the World Political Economy" (Princeton: Princeton University Press); WALTZ, K. N. (1979): "Theory of International Politics" (Reading: Addison Wesley); KRASNER, S. D. (1983): "International Regimes" (Ithaca: Cornell University Press), and many others.
69. KEOHANE, R. O. (1984), p. 52.
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161. MANSBACH, R. and J. VASQUEZ (1981), op. cit, p. 145.

162. For useful insights on this process, see the bibliography on group psychology in the Chapter five, endnote number .

163. ROSENAU, J. N. (1990), *op. cit*, p. 122.

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165. A complete list of group variations include: 1. Mobilized unitary actor, 2. Elite-directed unitary actor, 3. Active coalition, 4. Latent coalition, 5. Estranged potential faction, 6. Rebellious faction, 7. Estranged faction, and 8. Competing hostile actors. (MANSBACH and VASQUEZ, *op. cit*, p. 165-70).

166. ROSENAU, J. N. (1990), *op. cit*, 115.

167. *ibid*, p. 266-268.

168. National Association of Securities Dealers (1990): "An Introduction to the NASD", p. 2.

169. Federation of the German Stock Exchanges: "Annual Report 1990", p. 13.

170. *ibid*, p. 83.

171. Basic facts about the Association in: JSDA (1990): "An Introduction to the Japan Securities Dealers Association"

172. *ibid*, p. 2.

173. The Luxembourg Bankers' Association (1989): "Luxembourg - A multinational financial centre", p. 23.

174. The Luxembourg Bankers' Association (1989): "Fifty years", p. 10.

175. Other banking groups and associations represented in the BBA include: British Merchant Banking and Securities Houses Association, The American Banking and Securities Association of London, The British Overseas and Commonwealth Banks' Association, The Japanese Banks, The Committee of Scottish Clearing Bankers, Foreign Banks and Securities Houses Association, London Discount Market Association, and Northern Ireland Bankers' Association.

176. British Bankers' Association: "Annual Report 1992", p. 41.

177. British Bankers' Association: "Annual Report 1991", p. 24.

178. More details about these directives will be presented in the seventh chapter, where the analysis will focus the agenda formation and different issues in the debate.

179. British Bankers Association: "Annual Report 1992", p. 6.

180. British Bankers' Association: "Annual Report 1991", p. 4.

181. British Bankers' Association: "Annual Report 1992", p. 21.

182. The Banking Federation of the European Community was set up in 1960 to represent the interests of banks at EC level. It provides a forum for a continual dialogue both with the EC Commission and with other European institutions. It consists of the representatives from twelve national banking associations.

183. British Merchant Banking and Securities Houses Association: "Annual Report 1991", p. 6.
184. British Merchant Banking and Securities Houses Association: "Annual Report 1990", p. 5.
185. The Random House Dictionary of the English Language (1983), p. 743.
186. International Primary Market Association (1990): "Memorandum and Articles of Association".
187. *ibid*, p. 9.
188. *ibid*, p. 2.
189. The status of a Designated Investment Exchange, granted by the UK SIB, is the recognition that an overseas exchange "appears to SIB to have operating procedures broadly equivalent to those of Recognized Investment Exchanges. Although designation does not carry any guarantee to potential UK investors, it does let them know that an exchange meets certain basic criteria". (Securities and Investment Board: "Financial Services - A Guide to the Regulation of Investment Business, p. 12)
190. For explanations about these instruments, see Chapter Three of the analysis.
191. Figures for 1990, from: International Securities Market Association: "Statutes, By-Laws, Rules and Recommendations - January 1992".
192. International Securities Market Association (1992), p. 6.
193. Association of International Bond Dealers (1990): "An Introduction", p. 3.
194. For the importance of improving the technological infrastructure of the global securities market, see Chapter Two, section four, of the analysis.
195. LANGTON, J.: "The role of practitioners and self-regulatory organisations in the regulation of financial services", paper presented at the 15th Annual IOSCO Conference in London, October 1992.
196. International Federation of Stock Exchanges: "Annual Report 1990", p. 29.
197. *ibid*, p. 95.
198. *ibid*, p. 93.
199. A closer look at these and other regulatory measures will be taken in the following chapter, as an introduction to the agenda formation.
200. Securities and Investment Board (1991), p. 4.
201. *ibid*, p. 14.
202. Speech given by LARGE, Andrew, Chairman of the Securities and Investments Board, at the 17th IOSCO Annual Conference, London, 1992, p. 5.
203. Four Self-Regulating Organizations are: SFA, IMRO (fund managers), LAUTRO (life assurance and unit trust salesmen) and FIMBRA (financial intermediaries).
204. The Securities and Futures Authority (1991): " An Outline of the SFA", p. 3.
205. More details about the rules in: The Securities and Futures Authority (1991) "Report and Accounts", p. 13-14.

206. The Securities and Futures Authority (1991): "Introducing the SFA", p. 4.
207. *ibid*, p. 18.
208. The Pecora Committee was actually a subcommittee of the Senate Committee on Banking and Currency, formed in 1929 and chaired by Ferdinand Pecora.
209. CAMPBELL, T. S. (1982): "Financial Institutions, Markets and Economic Activity" (New York: McGraw-Hill), p. 391.
210. These laws include: the Securities Act of 1933, the Securities and Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.
211. US Securities and Exchange Commission (1988): "The Work of the SEC", p. 5.
212. More details about the National Market System in: CAMPBELL, T. S. (1982), *op. cit.*, p. 398-401.
213. US Securities and Exchange Commission (1988), p. 14.
214. The US Securities and Exchange Commission (1984): "Good people, important problems and workable laws", p. 73.
215. Speech given by Mr Richard Breeden, Chairman of the US SEC, at the 17th IOSCO Annual Conference, London, 1992.
216. Details about the work of the Committee will be presented in the following subsection, which will analyze international organizations in the field.
217. GALBRAITH, J. K. (1979): "The Great Crash 1929" (New York: Avon Books), p. 147.
218. The term "Iquango" was originally coined by P. WILLETTS, in: "Transactions, Networks and Systems" in: GROOM, A. J. R. and P. TAYLOR (eds.) [1990], *op. cit.*
219. WILLETTS, P. (1993): "Transnational Actors and Changing World Order", Occasional Papers Series Number 17 (Yokohama, Japan: International Peace Research Institute Meigaku), p. 24.
220. G. UNDERHILL, for example, argues that "IOSCO is a non-governmental institution in the international domain... Important decisions about the structure of international capital markets are being taken by non-state bodies outside the traditional legislative process." ("Keeping Governments out of Politics: IOSCO, the Internationalisation of Securities Markets, and the Question of Regulation" [University of Warwick, 1993, Working Paper No. 118], p. 2.)
221. For more details about quangos and independent regulatory commissions, see: The Blackwell Encyclopedia of Political Science (1991), p. 284-285, 513.
222. International Councils of Securities Association (1989): "An Introduction", p. 2.
223. International Councils of Securities Associations: 1992 Osaka Communique, p. 2-3.
224. *ibid*, p. 3.
225. International Organization of Securities Commissions: "Annual Report 1991", p. 14.
226. *ibid*, p. 4.

227. Speech given by Mr R. Breeden (US SEC), Chairman of the Technical Committee, at the 17th IOSCO Annual Conference, London, 1992.
228. Speech given by Mr D. S. Ruder, Chairman of the Consultative Committee, at the 17th IOSCO Annual Conference, London, 1992.
229. IOSCO News, February 1992, p. 1.
230. International Organization of Securities Commissions: "Annual Report 1990", p. 8-9.
231. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
232. More details about the Concordat, in: HALTMAN, C. W. (1990): "The Environment of International Banking" (New Jersey: Prentice-Hall), p. 243-244.
233. Liquidity pertains to a bank's ability of converting assets into (more liquid) money, to satisfy the needs of depositors. Solvency presents a bank's ability to secure a level of income or receipts over time which exceeds operating costs and provides a normal rate of return.
234. For more details about the Concordat supplements, see: Basel Committee on Banking Supervision (1992): "Report on International Developments in Banking Supervision" (Basel: BIS), p. 10-18.
235. The target standard ratio of capital to weighted risk assets was set at 8 percent, of which the core element (equity capital and disclosed reserves) would be at least 4 percent. It was expected to be observed by international banks by the end of 1992.
236. COOKE, P.: "International Convergence of Capital Adequacy Measurement and Standards", in: GARDENER, E. P. M. (ed.) [1990]: "The Future of Financial Systems and Services" (London: Macmillan), p. 311.
237. Basel Committee on Banking Supervision (1990): "Information flows between banking supervisory authorities", p. 2.
238. *ibid*, p. 5.
239. Basel Committee on Banking Supervision (1983): "Principles for the supervision of banks' foreign establishments" (Basel: BIS), p. 3.
240. Basel Committee on Banking Supervision (1992), *op. cit*, p. 4-5.
241. The Offshore group of Banking Supervisors comprises representatives from main off-shore financial centres, like Bahamas, Bermuda, Cayman Islands, Panama, etc. For details see: Basel Committee on Banking Supervision (1992), p. 126-127.
242. During the period between September 1990 and March 1992, US bank holding companies that report to Federal Reserve increased their core (tier 1) capital by 12 percent. The Tier 1 risk-based ratio increased from 6.5 to 7.9, and the total risk-based ratio improved from 9.5 to 11.3 percent. (Source: FEDERAL RESERVE BANK OF NEW YORK: QUARTERLY REVIEW, Autumn 1992, p. 13.)
243. The 7th International Conference of Banking Supervisors was held in Cannes, in October 1992, gathering authorities for more than one hundred countries and 8 international organizations. Two main topics were discussed: the role of banking supervision in the prevention of systemic risk, and supervisors' international cooperation.

244. Speech given by E. Gerald Corrigan (FRB of New York), Chairman of the Basel Committee, at the 7th International Conference of Banking Supervisors, Cannes, France, October 1992.

245. Council Directive 88/361/EEC, Official Journal of the EEC L 178, 8.7.1988.

246. Directive 89/646/EEC; OJ L 386, 1989

247. COM (89) 629, OJ C 43, 1989 and OJ C 42, 1990.

248. COM (90) 141, OJ C 152, 1990.

249. Basel Committee on Banking Supervision (1992), p. 119.

250. The reciprocity requirement and its impact on regime formation / characteristics were analyzed in Chapter Five, section 3.

251. The Delors Committee was set up in 1988, comprising governors of EC central banks, to examine the question of greater monetary cooperation. In April 1989, they finalized the "Report on Economic and Monetary Union in the European Community". For more details see: "The European financial common market", 1989 (Luxembourg: European Documentation), p. 46-52.

252. OECD (1991): "The OECD Declaration and Decisions on International Investment and Multinational Enterprises: 1991 Revision - Report by the Committee on International Investments and Multinational Enterprises" (DAFFE/IME (91) 23), p. 8.

253. For the list of all operations treated as capital movements, see: OECD: "The Code of Liberalisation of Capital Movements", Annex A (Paris: OECD, 1990)

254. The OECD declaration and Decisions on International Investment and Multinational Enterprises, Basic Texts, Foreword by the Secretary-General (Paris: OECD, 1992), p. 1.

255. *ibid*, p. 17.

256. The Group of Eminent Persons was appointed by the Secretary-General in 1972, to study the impact of transnational corporations on world development, international relations and national policies. The Group conducted a broad study, including the views of governments, TNCs, labour unions, consumer groups and universities. (Source: UNITED NATIONS: "Summary of the Hearings before the Group of Eminent Persons to Study the Impact of Multinational Corporations on Development and on International Relations", UN Publications, Sales No. E.74.II.A.9)

257. MOUSOURIS, S. "Codes of conduct facing transnational corporations", in: WALTER, I. (ed.) [1988]: "Handbook of International Business" (New York: John Wiley and Sons), p. 9.10.

258. *ibid*, p. 9.15.

259. UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS: "Transnational Corporations, Services and the Uruguay Round" , ST/CTC/103, (1990), p. 219.

260. Besides the already mentioned Offshore Group of Banking Supervisors, there are: Commission of Latin American and Caribbean Banking Supervisory and Inspection Organization, the SEANZA Forum of Banking Supervisors, the Gulf Countries Committee of Banking Supervisors, the Group of Banking Supervision Officials in Arab Countries, the Group of Banking Supervisors from Central and Eastern European Countries, and the Caribbean Group of Banking Supervisors. For more details about these groups, see: Basel Committee on Banking Supervision (1992), note 234.

261. KEOHANE, R. and J. NYE (1989), p. 24-37.



262. All the references to issue- and policy-systems are made here according to: WILLETTS, P. with M. BENTHAM, P. HOUGH and D. HUMPHREYS (1992): "The Issue of Issues in Regime Theory" (London: City University).

263. *ibid*, p. 13 and 23.

264. MANSBACH, R. W. and J. A. VASQUEZ (1981): "In Search of Theory. A New Paradigm for Global Politics" (New York: Columbia University Press), p. 93-94.

265. Activities of each of these organizations in relation to transnational code of business conduct will be examined later, in the context of concrete agenda proposals.

266. Details about these organizations can be found in Chapter Six, second section.

267. MANSBACH, R. W. and J. A. VASQUEZ, *op. cit*, p. 110.

268. For details, see the concluding part of the previous chapter.

269. Although this part of the analysis follows the analytical path developed by MANSBACH and VASQUEZ (1981, p. 102-107), the list of factors influencing salience is not taken in its entirety. The fifth factor, offered by the authors, is "... the extent to which these stakes are sought" (*op. cit*, p. 102): stakes can be intrinsic (immediate value impact) or instrumental (indirect value impact, through other objects or stakes). As this factor resembles the distinction between different types of stakes (concrete, symbolic, transcendent) to a great extent, it was omitted from this analysis.

270. For the differences between these two concepts, see: WILLETTS, P. et al. (1992), p. 9-23.

271. MANSBACH and VASQUEZ, *op. cit*, p. 110.

272. For details, see: MANSBACH and VASQUEZ, *op. cit*, p. 113-124.

273. *ibid*, p. 113-114.

274. *ibid*, p. 88.

275. Consolidated accounts are financial statements that include the balance sheets and profit and loss accounts of parent and subsidiary companies. (The Penguin International Dictionary of Finance, 1989, p. 52)

276. Basel Committee on Banking Supervision (1983): "Principles for the supervision of banks' foreign establishments" (Basle: BIS), p. 1.

277. For details of the recommendations, see: Basle Committee on Banking Supervision (1990): "Information flows between banking supervisory authorities".

278. For details about strengthening international cooperation in this field, as well as about the Minimum standards, see: Basle Committee on Banking Supervision (1992), p. 10-18.

279. CORRIGAN, E. G.: "Challenges Facing the International Community of Bank Supervisors", in: FEDERAL RESERVE BANK OF NEW YORK: QUARTERLY REVIEW, Autumn 1992, Volume 17, Number 3, p. 1.

280. OJL 386/1, 30. 12. 1989, p. 61-73.

281. A compendium of the EC banking directives, related to harmonisation of bank regulation, was made by the British Bankers' Association in June 1990. These directives include: the 1983 Consolidated Supervision Directive (83/350/EEC), the Second Banking Directive (89/646/EEC), the

Solvency Ratio Directive (89/647/EEC), and the Recommendation on Large Exposures (87/62/EEC).

282. The Investment Service Directive (Proposal 90/C 42/06), OJC 42, 1990.

283. On its 1987 Annual Conference in Brazil, IOSCO issued the so-called Rio Declaration (till 1992, it was signed by almost half of the members), which calls upon members to provide assistance on a reciprocal basis in the gathering of information. This is primarily related to market oversight and protection of investors against fraudulent securities transactions. (IOSCO, Annual Report 1990)

284. International Organization of Securities Commissions (1991): "Final Communiqué of the XVI Conference of the IOSCO", and The 1991 Annual Report.

285. IOSCO (1991), "Final Communiqué", Appendix B, p. 2

286. The International Capital Market Group (1992): "Self-Regulation of the Securities Markets". The Group is composed of representatives of the FIBV, the International Federation of Accountants, and the International Bar Association.

287. For a full list of self-regulatory rules and standards, see: International Federation of Stock Exchanges: "Annual Report 1992", p. 60-61.

288. "The Report on Information Sharing Agreements", presented by the FIBV Subcommittee on International Regulation at the "Seminar of Self-Regulators", jointly sponsored by the FIBV and the Stockholm Stock Exchange and held in Stockholm in March 1992.

289. International Federation of Stock Exchanges (1992), p. 62.

290. KAY, J.: "The forms of regulation", in: SELDON, A. (ed.) [1988]: "Financial Regulation - Or Over-regulation" (London: Institute of Economic Affairs), p. 34.

291. RUDER, D. S.: "The role of practitioners and self-regulatory organisations in the regulation of financial services", paper delivered at the 17th IOSCO Annual Conference in London, 1992.

292. Speech given by Mr A. Lange, Chairman of the Securities and Investments Board, at the opening of the 17th IOSCO Annual Conference, London, 1992.

293. RUDER, D. S., op. cit, p. 5-6.

294. The International Federation of Stock Exchanges (FIBV): "Annual Report 1992", p. 95.

295. "Securities houses face capital clampdown", EUROMONEY, April 1992, p. 35.

296. FITCHEW, G.: "The Regulation of International Financial Conglomerates", paper presented to the 17th IOSCO Annual Conference, London, 1992, p. 2.

297. *ibid*, p. 2.

298. "Securities houses face capital clampdown", EUROMONEY, April 1992, p. 33. (For details about regulatory differences in major financial centres, see Chapter Two)

299. Paradoxically, portfolio theory was developed in the US at the beginning of the 1950s, by H. Markowitz. Portfolio theory rests on the assumption that risk can be reduced by diversifying holdings of assets,

300. IOSCO News, February 1992.

301. KAPSTEIN, E. B.: "Between power and purpose: central bankers and the politics of regulatory convergence", in: INTERNATIONAL ORGANIZATION, vol. 46, no. 1, Winter 1992, p. 281.

302. Two excellent articles on the historical background of The Capital Accord are: KAPSTEIN, E. B.: "Resolving the regulator's dilemma: international coordination of banking regulations", in: International Organization 43, 2, Spring 1989; and COOKE, P.: "International Convergence of Capital Adequacy Measurement and Standards", in: GARDENER, E. P. M. (ed.) [1990]: "The Future of Financial Systems and Services" (London: Macmillan).

303. MAXWELL, T., Introduction to "International Convergence of Capital Measurement and Capital Standards" (Basle, 1988).

304. Basel Committee on Banking Supervision (1988): "International Convergence of Capital Measurement and Capital Standards", p. 2.

305. These provisions were mainly related to identified deterioration in the value of particular assets, credit risk and the inclusion of certain general funds (from retained earnings) in core capital. More details about this in: Basel Committee on Banking Supervision (1992), op. cit, p. 19-25.

306. Undisclosed (hidden) reserves relate to an undervaluation of assets or an overvaluation of liabilities, and are not adequately transparent. Revaluation reserves comprise any surplus arising from the revaluation and sale of assets. Hybrid debt capital instruments include, for example, cumulative preference shares (UK) and mandatory convertible debt instruments (US). They can be included in the capital if they are unsecured, subordinated, fully paid-up and not redeemable. Subordinated term debt includes conventional unsecured debt instruments, with the maturity of over five years, and are not normally available to participate in the losses of a bank.

307. For a comparison of bank capital in some US, Japanese, German, French and British banks, see: THE ECONOMIST - A Survey of World Banking, May 2nd, 1992, p. 6.

308. The own funds of a credit institution can serve to absorb losses and for the assessment of the institution's solvency, and closely resembles the Basle Committee's definition of core and supplement capital. (Directive 89/299/EEC OJL 124/16).

309. OJL 386/14, 30. 12. 1989.

310. For details about the report see: IOSCO Annual Report 1990, and "Banks under stress" (Paris: OECD, 1991), Chapter 5.

311. A company needs to allocate its capital according to adverse price movements: a price fall for long positions, and a price rise in short positions. These risk requirements should be determined on the historical price fluctuations of each type of issue, the nature of the issuer, the liquidity of the market for a security and its ratings. In addition, a base capital requirement should be imposed against other unmeasurable risks. This approach is widely used, most notably in the UK, US and Japan.

312. IOSCO Annual Report 1991, p. 6-7.

313. COM(90) 141 final - SYN 257, published in OJL 152/6 21. 6. 1990.

314. For example, claims on central governments and European Community, up to 3 months maturity, carry the weight of 0.3 percent. At the other extreme, claims on other issuers (e.g. companies which are not listed on a stock exchange), with maturity over 20 years, carry the weight of 15 percent. (OJL 152/13)

315. COM(92) 13 final - SYN 257, published in OJL 50, 25. 2. 1992.

316. Explanatory Memorandum to the CAD, p. 2.
317. These weighting are: zero for central governments items; 0.25 percent for qualifying items of up to six months' maturity; 1 percent for qualifying items of six months' to two years' maturity, 1.6 percent for over two years, and 8 percent for other items. (OJC 50/13)
318. For details about both approaches, see: Basle Committee on Banking Supervision (April 1993): "The Supervisory Treatment of Market Risks - Consultative proposal".
319. Amended proposal for a council directive on investment services in the securities field (ISD), (COM(89)629). This will be analyzed in more detail in the following subsection.
320. "Securities houses...", EUROMONEY, April 1992, p. 33.
321. OECD "Code of Liberalization of Capital Movements", Articles 1 and 2 (Paris: OECD, 1990).
322. OECD "Declaration on International Investment and Multinational Enterprises", June 1976.
323. For a full survey of restrictions see: "Code of Liberalization of Capital Movements" Annex B, and "Banks under stress", op. cit.
324. OECD "Code of Liberalization of Current Invisible Operations" (Paris: OECD, 1990), p. 9.
325. National regulators from the EC members: Belgium, Denmark, Luxembourg and Portugal, are neither required nor they have the discretionary power to approve foreign establishment on conditions of reciprocity.
326. SELF, R.: "International discussions on trade in services: The perspective of developed countries" in: UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS (1989): "Service and Development: The Role of Foreign Direct Investment and Trade" (New York: UNCTC), p. 167.
327. SHUKLA, S.: "International discussions on trade in services: The perspective of developing countries", in: "Service and Development...", op. cit, p. 173.
328. For a detail discussion, see: RICHARDSON, J. and J. SCHEELE: "Appropriate regulation and other concepts", in: "Services and Development...", op. cit, p. 151-155.
329. For an excellent analysis of the Uruguay Round, GATT and the relationship between politics and markets at both the domestic and international levels, see: UNDERHILL, G. "The Uruguay Round and financial openness", in: CERNY P. G. (ed.) [1993]: "Finance and World Politics" (Edward Elgar Publ.)
330. These Directives include: 1) the 1987 Directive amending the First Directive of 11 May 1960 for the implementation of Article 67 of the EEC Treaty, and 2) Council Directive 88/361/EEC on the establishment of a European financial common market; (Source: "The European Financial Common Market", European Documentation, Periodical 4/1989)
331. First Council Directive on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (77/780/EEC, published in OJL 322 17. 12. 1977)
332. Second Council Directive on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC (89/646/EEC, published in OJL 386 30. 12. 1989)
333. *ibid*, the Preamble

334. British Bankers' Association: "The EC Banking Directives of 1989 - A Compendium", op. cit, p. 26-27.

335. Most important Directives include: 1) Directive coordinating the conditions for the admission of securities to official stock exchange listing (79/279/EEC); 2) Directive coordinating the requirements for drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (80/390/EEC); 3) Directive on information to be published on a regular basis by companies the shares of which have been admitted to official stock exchange listing (82/121/EEC).

336. Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), 85/611/EEC. It was amended in three years later: 88/220/EEC.

337. Directive amending Directive 80/390/EEC coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing (87/345/EEC).

338. Amended proposal for a council directive on investment services in the securities field (COM(89)629, published in OJL 42, 22. 02. 1990)

339. THE BANKER, July 1993, p. 12.

340. UNITED NATIONS CONFERENCE ON TRADE AND EMPLOYMENT, UN Sales No. 1948.II.D.4.

341. The most important are resolutions on permanent sovereignty over natural resources; the International Development Strategy for the 1960s and 1970s; the 1980 UNCTAD "Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, and the 1978 UNCTAD "International Code of Conduct on the Transfer of Technology" (not adopted).

342. OECD "Declaration and Decisions on International Investment..." (see note 322)

343. The Draft United Nations Code of Conduct on Transnational Corporations, in: UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS (1990): "Key Concepts in International Investment Arrangements and Their Relevance to Negotiations on International Transactions in Services" (Current Studies, Series A, No. 13)

344. Commission recommendation concerning a European code of conduct relating to transactions in transferable securities (77/534/EEC, published in OJL 212, 20. 8. 1977)

345. *ibid*, p. 38.

346. *ibid*, p. 41.

347. IOSCO Annual Report 1990, p. 8-9.

348. FIBV "Generally accepted principles of securities business conduct" (FIBV, Annual Report 1992, p. 91-93)

349. As already mentioned in Chapter Six (section 6.2.1.5.), the Joint Money Laundering Steering Group was formed in the UK, drawing representatives from nine Trade Associations, Bank of England and the National Criminal Intelligence Service. A revised version of the 1991 Money Laundering Guidance Notes was produced in 1993, to cover all the business of all investment firms within the UK jurisdiction. For details, see: Joint Money Laundering Steering Group: "Money Laundering - Guidance Notes for Wholesale, Institutional and Private Client Investment Business" (London, October 1993).

350. KRATOCHWILL, F. (1989): "Rules, norms and decisions" (Cambridge University Press), p. 48.
351. Average margins (measured by net interest income as a percentage of average interest-earning assets) rose from 3.81 percent, in 1990, to 4.40 percent in the beginning of 1993. (Source: THE BANKER, July 1993, p. 83).
352. *ibid*, p. 74-176.
353. According to the survey, capital ratio for the leading US banks varies between 11 and 13 percent, for the biggest UK banks it is between 10.5 and 11.5 percent, and for the leading Japanese ones is between 8 and 9.5 percent. Most of the biggest German banks had not reported the ratio.
354. LANGTON, J. L., International Securities Market Association Report to the 1992 Annual General Meeting of the International Councils of Securities Association, p. 1.
355. For details about TRAX and other computer networks in modern banking, see Chapter Two, section five of this study.
356. The International Securities Market Association: Statutes, Article 15.c. (Zurich, 1992)
357. Derivatives, which include futures, options and swaps, are special contracts whose value reflects movements in the price of underlying assets (equities, bonds, commodities). "Over-the-counter" derivatives are customised contracts provided by investment banks for particular clients' needs.
358. THE ECONOMIST, June 26 1993, p. 106.
359. For a particularly comprehensive survey of derivative instruments, see: "GLOBAL FINANCE - The Derivatives Handbook", Volume 7, Number 6, June 1993 (New York).
360. A series of articles on Globex appeared, *inter alia*, in "FINANCIAL TIMES" on April 10 1992; June 25 1992; June 30 1992, etc.
361. THE ECONOMIST, May 8 1993, p. 100.
362. Several years ago, the biggest buyers of global equities were investors from Japan and the UK, mostly interested in US equities. In both 1991 and 1992, net US purchases of foreign equities amounted to around 50 billion dollars (Source: THE ECONOMIST, May 8 1993).
363. FINANCIAL TIMES, May 22 1992.
364. FINANCIAL TIMES, October 8 1992; February 10 1993; December 18 1993.
365. THE ECONOMIST, June 19 1993, p. 19.
366. "Japanese Financial Markets", FINANCIAL TIMES, March 24 1993.
367. PREKAJAC, Z. (1994): "International Trade in Services", unpublished PhD dissertation, University of Belgrade.
368. For details, see: Basle Committee on Banking Supervision (April 1993): "The Supervisory Treatment of Market Risks" (Basel: BIS).
369. *ibid*, p. 2.
370. FINANCIAL TIMES, June 1 1992, p. 30.

371. FINANCIAL TIMES, May 26 1993.

372. FINANCIAL TIMES, November 3 1993.

373. For details about this approach, see: GERMAIN, R.: "Free Trade and Finance in North America: Towards a Regional Financial Block?", paper presented at the 1993 Annual Conference of the British International Studies Association, Warwick.

APPENDIX

*Main political actors: types and preferences*

	<i>country of origin</i>	<i>est.</i>	<i>type</i>	<i>organiz. joined</i>	<i>ranking of values</i>
National Association of Securities Dealers NASD	United States	1938	NGO	ISMA, BMBA, IOSCO, FIBV, ICSA	efficiency freedom order
Federation of German Stock Exchanges	Germany	n.a.	NGO	FIBV, IOSCO	order safety efficiency
Japan Securities Dealers Association JSDA	Japan	1973	NGO	IOSCO, ICSA	order safety efficiency
Luxembourg Bankers' Association ABBL	Luxembourg	1939	NGO	n.a.	efficiency safety
British Bankers' Association BBA	United Kingdom	n.a.	NGO	IOSCO	efficiency freedom safety order
British Merchant Banking and Securities Houses Association BMBA	United Kingdom	1988	NGO	BBA	efficiency freedom equality
International Primary Market Association IPMA	United Kingdom	1984	INGO	ISMA	efficiency
International Securities Market Association ISMA	Switzerland	1969	INGO	IOSCO, ICSA	freedom efficiency order safety



	<i>country of origin</i>	<i>est.</i>	<i>type</i>	<i>organic. joined</i>	<i>ranking of values</i>
International Federation of Stock Exchanges FIBV	Switzerland	1961	INGO	n.a.	efficiency order safety
International Councils of Securities Associations ICSA	n.a.	1988	Iquango	n.a.	order safety freedom
Securities and Investment Board SIB	United Kingdom	1988	quango	ICSA, IOSCO	efficiency safety order
Securities and Futures Authority SFA	United Kingdom	1991	quango	n.a.	efficiency safety order
Securities and Exchange Commission SEC	United States	1934	quango	IOSCO	order safety
International Organization of Securities Commissions IOSCO	Canada	1986	Iquango	n.a.	efficiency freedom order safety
Basle Committee on Banking Supervision	Switzerland	1974	IGO	n.a.	safety order equality
EC Banking Advisory Committee	-----	1977	IGO	n.a.	safety efficiency

	<i>country of origin</i>	<i>est.</i>	<i>type</i>	<i>organiz. joined</i>	<i>ranking of values</i>
EC Banking Supervisory Sub-Committee	-----	1990	IGO	IOSCO	order safety
OECD Committee on International Investments	-----	1975	IGO	n.a.	freedom equality order

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