Neoliberal Diffusion of Financial Regulatory Rules: Bridging Domestic and International Explanations

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Abstract:

The 2008 financial crisis that originated from the United States has caused global economic downturns in fear of plunging into a great recession. As situation evolves, the regulatory problems of this systematic risk that spread from national to global levels should be detected and analyzed. This paper aims at tracing the origin and diffusion of neoliberal financial governance in the past three decades, which have paved way for today's financial disaster. A perspective that bridges domestic regulatory foundation and international diffusion of rules should be in place to better grasp the nature of current crisis. At domestic side, a perspective of "regulatory capture" in which special interests, regulatory incompetence of public institutions and the dogmatic ideologies all together contributed to this crisis. The regulatory capture further constrains policy options and impacts the following path of financial sector restructuring. In the wake of the U.S. financial meltdown, the Obama administration makes efforts to reform the financial sector. The latest reform bills proposed by the House and the Sendate signal US government' attempts to tame giant financial institutions. For global implications, the U.S. crisis may jeopardize the credibility of global financial norms that have been promoted by advanced countries. It deserves special attention on tracking how the latest US reform proceeds and how an international agreements will be reached in the G20 meeting in November.

Keywords: embedded neoliberalism, diffusion, convergence, divergence, club standard, regulatory capture, moral hazard, 2008 financial crisis, 1997 Asian financial crisis, financial governance

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I. An Overarching Perspective on Global Financial Governance

The 2008 financial crisis that originated from the United States has caused global economic downturns in fear of plunging into a great recession. As situation evolves, the nature of this systematic risk that spread from national to global level, or more specifically stated, from developed to developing countries, should be detected and analyzed. This paper proposes an overarching framework of "embedded neoliberalism" to address how financial liberalization and deregulation has established itself as dominant neoliberal financial order and diffused from advanced to developing world. The neoliberal world order should have rested on compatible domestic foundation of regulation in order to prevent financial stability and crisis from happening. However, since the 1980s, we witness the increasing volume of capital mobility, the corresponding urge for uplifting restrictions on capital-account liberalization, and a series of emerging-market crises, beginning with Mexico in 1994-95, Asia in 1997-98, Russia in 1998, Argentina in 2001-92, Brazil in 2001-02, Turkey in 2000-02 (Goldstein and Xie, 2009: 21), then culminating in the 2008 crisis in the U.S. The trend in the past three decades appear to move toward more financial ventures into the developing countries (or the so-called emerging markets), the proliferation of financial derivatives of different kinds, but less regulations on bank mergers and on the emergence of giant holding financial companies that combine banking, security, and insurance in one. The embedded neoliberalism in the era of globalization, which is supposed to strike a balance between domestic regulation and global expansion, suffers from structural weakness of regulatory governance.

This paper suggests that the risk of "regulatory capture" is especially high once unbridled special interests, regulatory incompetence of public institutions and the dogmatic neoliberal ideology work together. The proclivity toward capital logic and preference undermines the regulatory foundation of embedded neoliberalism. The regulatory capture further constrains policy options and impacts the following path of financial sector restructuring. How and why the crisis occurred and evolved can shed light on what can be reformed and what cannot be redressed. The U.S. crisis may jeopardize the credibility of global financial norms that have been promoted by advanced countries. Regional responses, especially from East Asia, deserve particular attention.

The first part of this paper is to detect the structural root of the 2008 crisis by focusing on the regulatory capture of the "embedded neoliberalism" in the United States. With the perspective of embedded neoliberalism, I will trace the diffusion mechanisms of norms, rules, and ideology about financial sector restructuring and explore how policy convergence was adopted in other context, e.g. the 1997 Asian crisis. The second section will explore the nature of global standards and codes of financial regulation, which have been held as orthodox rules by the United States and its European counterparts to endorse capital liberalization. Why did the orthodox regulation not prevent the U.S. financial crisis from happening? The final section of this paper will make an observation and a tentative comment on the current financial regulatory reforms in the United States.

II. Institutional Foundation of Embedded Neo-Liberalism: Hegemonic Regulation or Great Powers Concert?

John Ruggie (1982) invented the term, "embedded liberalism", to portray the postwar international order. He emphasized that the maintenance of the liberal world order, which was built upon three pillars, the GATT, the IMF and the World Bank, relied heavily on domestic management of adjustment to cushion external shocks. In other words, international liberal economic order should be embedded in domestic institutional foundation: Keynesian economic adjustment and compensation from external opening. The demise of embedded liberalism started with Nixson's termination of dollar's convertibility to gold in 1971. The collapse of fixed exchange rate regime and the U.S. balance of payment deficit signaled the demise of embedded liberalism; in the process the legitimacy of Keynesian state-centered management declined and monetarist ideology ascended (McNamara, 1998: 144-58). The advent of the neoliberal age beginning in the 1980s is in need of a post-Bretton Woods architecture to provide an international framework for expansion, while domestically the advocacy for a "regulatory capitalism" (Levi-Faur and Jordana, 2005; Levi-Faur, 2005) assigns the state a regulatory role in rapport with market. The tenets of embedded neoliberalism envisage specific domestic institutional configuration, in which the central bank, replacing traditional economic planning agency, assume a leading status for setting monetary targets and exercising monetarist management. Regulatory competence is delegated to independent regulatory agencies in keeping distance from direct political control. A bulk of empirical works mushroom on investigating how to sustain the new orthodoxy of "central bank independence" and regulatory commitment to credible policy changes (???Levy and Siller, 1994; Majone, 1997; McNamara, 2002; Keefer and Stasavage, 2003).

Internationally, a rule-based global financial order (Kerwer, 2005) severs as the mainstay to disseminating noliberal ideas and standards, therefore creating a competitive pressure for all countries to adopt. In the area of finance, if one fails to follow the trend, financial interests and multination business would opt for countries with financial markets wide open, liberalized and de-regulated. This triggers “a race to bottom in regulatory standards” (Kerwer, 2005: 619). The competitive pressure eventually swept all over the advanced countries, from the U.S., Britain, Germany, France, to all members of European Community by the end of 1980s (Helleiner, 1994: 146-63).

Neoliberal financial liberalization, replacing Keynesian capital control, became the new orthodoxy under which financial globalization was propagated to bring down national barriers for capital mobility. As far as financial sector regulation is concerned, an array of global standards and codes is proposed by G 7 officials, global governance institutions (IMF, Basel Commission, and other club arrangements), along with private sector financial actors to govern global finance (Mosley, 2009). It often imposes either on countries struck by financial crisis via policy conditionality with rescue loans (Finnemore and Sikkink, 1999; Haggard, 2000) or on countries suffered from severe payment problems via sovereign debt rescheduling (Callaghy, 2003). In short, the club of advanced countries (G7) set standards and task the IMF and World Bank with their global dissemination of the so-called “Washington Consensus” (Serra and Stiglitz, 2008). The embedded neoliberalism constitutes the new global order and seeks global diffusion (Slaughter, 1997; Biersteker, 1992).

Critics on and dissidents with the new financial orthodoxy often blame the “American hegemony” for the predominance of Anglo-American ideology and interests. Hegemonic stability theory, coined by Robert Keohane (1984), has been invoked to explain the functioning of the postwar international order under which U.S. “benign” leadership provides international public goods in terms of maintaining an open trade system and a dollar-centered monetary order. Nevertheless, with the collapse of the Bretton Woods system in 1971, neoliberal restructuring and globalization were gradually embraced by advanced countries as a whole. I suggest that, great powers concert, rather than hegemonic regulation, is the underlying architecture of neoliberal global order (Abdelal, 2006; 2007). To outsiders' surprise, according to Rawi Abdelal's research, policy shift in the French socialist government was the key to upend neoliberal orthodoxy and facilitate free capital movements within the Europe (Abdelal, 2007).

Even with the great powers concert in place (Helleiner, 1999: 144), which evolved from G7, G8 to G10 as a response to structural changes in world power, how to come up with international agreements on financial standards to foster capital liberalization still involves "redistributive" politics of rule-setting among great powers (Oatley and Nabors, 1998). Taking the instance of Basel capital adequacy standard setting, the Basel Committee of Banking Supervisors, a committee of supervisory authorities from the advanced industrial countries that meets regularly at the Bank for International Settlements in Basel, gathered in 1987, in December the G10 signed the Basel Accord on the International Convergence of Capital Measures and Capital Standards (Basel Accord). The far-reaching standard on global financial regulation sought to apply the same minimal capital requirements to all commercial banks. The genesis of the universal rule for all commercial banks actually started as the U.S. response to cope with the 1982 Latin American debt crisis, in which the excessive lending of American Commercial Banks to Latin American countries forced the U.S. government into bail-out. Yet, to alleviate public and Congressional objection to pouring money to rescue private banks, the U.S. government shifted attention from tightening domestic regulation to push forward an international agreement in raising capital requirement for all commercial banks around the globe. The efforts not only mitigated against banks' repercussion for the decrease of lending profits, but also dragged the European and Japanese banks into the regulatory game, thus leveling the playing field for all the market participants (Oatley and Nabors, 1998: 42-46). With the intention of redistribution of wealth veiled behind the rule-setting negotiation, American regulatory authority eschewed more strict discipline on banking sector and demonstrated how agenda-setting and rule-making power generates redistributive consequences. The Basel Accord has been held as an internationally accepted standard for best supervisory practice.

As illuminated from the case of Basel Accord, the regulatory foundation of embedded neoliberalism espoused by great powers concert has tipped toward market-based measures. As financial liberalization and globalization proceeds, the financial sector is no longer predominantly composed of traditional commercial and industrial banks. Private banking, institutional investors (such as investment bank, insurance companies, mutual fund, pension funds and managed-futures funds), together with highly leveraged institutions (such as hedge funds) are, instead, influential players at home and in emerging markets. The capitalization of large offshore hedge fund can sometimes outnumber the reserves of most emerging-market central banks (Eichengreen, 2003). The overlapping networks of different financial intermediaries await clearing up regulatory ambiguity, such as responsibilities among central bank, security commission, financial supervisory commission and finance ministry, and how they are coordinated to cope with the systemic risk of financial crisis (Germain, 1997: 152).

The original Basle standards defined minimum capital ratios for different classes of financial assets, The revision of the Basle Capital Adequacy Standards for International Banks allows banks to estimate their own capital requirements by using their own model of portfolio risk (Eichengreen, 2003: 194). The resort to self-evaluation approach veiled by the euphemism of “private sector risk management” reveals the intractability of new financial practices. As Barry Eichengreen puts, “Advances in computing have made it easier for financial engineers to concoct and price derivative financial securities, in turn encouraging the development of liquid secondary markets in these assets. This has made it easier for portfolio managers to arbitrage regulatory requirements--- to securitize assets-- and shift them off of the balance sheet without altering overall portfolio risk” (Eichgengreen, 2003: 194-5)

While developing countries fend themselves with national regulation or capital control, the advanced countries often favor market discipline as the elf-regulating mechanism. Club organizations, such as the Basel Committee of Banking Supervisors and the Financial Stability Forum (FSF), which was established in early 1999, both are to provide a venue for discussion and agenda-setting. Global economic governance organizations, such like the IMF and World Bank, then put these neoliberal standards into implementation (Eichengreen, 2003: 185-6). As Table 1 clear shows, the nature of the rules in global financial regulation thus far is the so-called “club standard,” which entails low conflicts among great powers, but possesses high conflicts and divergent interests between club members and other developing countries. Table 2 also summarizes how different types of regulation are linked with specific type of politics.

Table 1. A Typology of Regulatory Coordination

		Divergence of interests between great powers and other international actors	
		High conflicts	Low conflicts
Divergence of interests among great powers	High conflict	Sham standards	Rival standards
	Low conflict	Club standards	Harmonized standards

Source: Drezner, 2007: 72.

Table 2 Typology of Regulatory Politics

Dispersion Costs	Dispersion Benefits	Type of Politics	Example
Wide	Wide	Majoritarian politics	Tax policy
Narrow	Narrow	Interest-group politics	Industrial subsidies
Narrow	Wide	Entrepreneurial politics	Environment
Narrow	Narrow	Client politics (small-group capture)	Financial regulation

Source: Laurence, 2001: 38.

According to the study of Daniel Drezner (2007: 136-7), half of the financial codes and standards emanated from club international governmental organizations or private orders. The Financial Stability Forum (FSF) was regarded as a club of clubs, heavily representing G7 interests. Only one of the agreed-upon standards took the different stages of development into consideration. In other words, these standards may well constitute a ratcheting up of stringency for the developing countries.

Elkins and Simmons (2005) propose that policy diffusion usually occurred on waves and clusters. A wave of neoliberal rule-semination has emerged in the wake of the 1997 Asian financial crisis, since crisis situation serves as the best catalyst for the promotion of ideation and institutional changes in developing world. The IMF report after the Asian crisis suggested the disclosure of information on trades, positions, and detailed portfolio reporting of whose approach preferred information-based discipline over direct regulation (Eichengreen, 2003). The World Bank and the IMF systematized "eleven areas where standards are important for the institutional underpinning of macroeconomic and financial stability" (Soederberg, 2003: 8). The international standards on "data dissemination, fiscal practices, monetary and financial policy transparency, banking supervision, insurance supervision, securities market regulation, payment systems, corporate governance, accounting, auditing, insolvency regimes, and creditor rights" (Soederberg, 2003: 8). Ostensibly, global regulatory standards seem softer than legal rules by giving sovereign states more regulatory autonomy (Kerwer, 2005). Yet the harmonization of regulatory standards is conducive to eradicating national differential treatments on and barriers to globally mobile capital. The Asian financial crisis sprang up the proliferation of so-called "good governance practices" that attempts to establish "comprehensive webs of surveillance in the interest of western institutional investors (Soederberg, 2003:9).

Some third world countries have questioned that why should the South accept and comply with these club standards that did not address the reckless and unstable nature of transnational financial capital. In this category, Malaysia government refused the IMF financing schemes and turned to its own capital control measures. South Korea, on the other extreme, capitulated to IMF pressures and went through sweeping financial and corporate sector restructurings in which business-government relations were questioned, chaebol was reconfigured, good corporate governance measures were introduced to protect shareholders' rights, restrictions on foreign banking investments were uplifted, and the competitiveness law was installed (Haggard, Lim and Kim, 2003).

The post-Bretton Woods era dwells on the rule-based global order. The trend breeds on literatures on legalization and policy diffusion in international political economy. The legalization school (Goldstein and Steinberg, 2009: 211-241) traces the prominent development in the WTO on harmonizing trade-related rules and establishing dispute settlement mechanism. As the Agreement on Technical Barriers to Trade of the World Trade Organization states, "where technical regulations are required and relevant international standards exist—Members shall use them—as a basis for their technical regulation." Failure to do so may constitute an obstacle to trade and thus a violation of WTO law (Mattli and Buthe, 2003:2). The harmonized international standards increasingly serve as instruments of trade liberalization to overcome national barriers of other countries. In the area of finance, internationally accepted frameworks of prudential banking supervision, such as the Basel I and Basel II Accords, and international agreed-upon standards on securities, accounting and insurance have an penchant for "voluntary information disclosure" and self-evaluation approach to govern mobile and volatile financial capital.

The literature on policy diffusion (Simmons, Dobbin, and Garrett, 2006; 2008; Simmons and Elkins, 2003), on the other hand, examines various mechanisms for disseminating mainstream policy “consensus.” Among the items on the list, competition, emulation, coercion and learning are routs to policy diffusion and ultimate policy convergence. Although encountered with the repulsion from the “varieties of capitalism” (VOC) thesis, which insists that particular institutional combinations of national capitalism cannot easily be swept aside by globalization, there is no gainsaying that neoliberal ideas, norms and rules have permeated into national practices, and gradually accepted as technically rational policy options to “link with globalization.” Then, an embarrassing question emerges, if the dominant neoliberal financial rules and standards are primarily promoted and practiced by the U.S.-centered authority, how come the U.S. became the epicenter of the 2008 financial meltdown? The following session turns to the U.S. case

III. Regulatory Capture of the U.S. Financial Governance

Few would have ever imagined that a suprime mortgage bubble burst in the summer 2007 kindled a series of financial institutions crisis. From Bear Stearns, Fannie Mae and Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, to Citigroup, the horrendous crisis hit the United States and damaged global economies. So far, only a limited consensus is reached on the causes of the 2007-09 crisis, not to mention what lessons are to be drawn from this economic and financial crisis. Senior economists generally pay attention to the following broad issue areas, which may, in combination, cause the crisis: The first category focuses on macroeconomic policy failures. The former chairman of Federal Reserve Board, Mr. Greenspan, was blamed for his monetary policies mistakes; his too low interest rates and too loose credit policy spurred housing booms and stepped up bubble economy (Johnson, 2009). His overall policies have encouraged borrowing in the first instance, and in turn encouraged excessive leverage among secondary market participants (Norland, 2009: 182).

The second category concerns failures of financial-sector supervision and regulation. The credit ratings agencies and regulators were scorned "asleep at the switch" and U.S financial regulation system being regarded "fragmented and inadequate." In conjunction with abundant liquidity and regulatory lassitude, a grand scale of frauds added to the systemic crisis (Noland, 2009: 182). The third category pays heed to the poorly understood, and thus poorly regulated, financial engineering. The Wall Street financial engineers designed derivatives and securitizations of multiple forms, from interest-rate options to more intricate credit-default swamps and collaterized debt obligations (The Economist, July 18th 2009). Risks of financial ventures have been wrapped as "financial products" for trading; risks were born by consumers all over the world.

The fourth category cares about the excessive risk taking on the part of large financial institutions in their global business (Truman, 2009). Decades of financial liberalization and integration have given rise to vertical and horizontal concentration of financial capital. Financial giants and securities firms have operated on the global reach. According to Simon Johnson's testimony to the US Congress, the handling of problematic giant financial institutions, conducted by the Treasury Department and the Federal Reserve, did not act on any coherent principle or legislation. Instead, regulators served as a "broker" mediating among troubled debtors and potential market buyers via government guaranteed capital injection. Given the nexus of Treasury and Wall Streets, US government acted carefully not to upset the interests of big finance and the terms of restructuring were apparently favorable to the banks (Johnson, 2009b), To salvage these giants easily falls into victim of the “too big to fall” principle of financial restructuring.

The above mentioned policy mistakes and regulatory failures seem predicated on “wrong policies” taken by individual decision-makers, or innocent ignorance on new forms of financial engineering. Mainstream arguments thus far eschew identification of structural causes involved in the ideas and practices of embedded neoliberalism. I maintain that “regulatory capture” by established financial interests has undermined the domestic foundation of embedded neoliberalism. Ten years ago, Randall D. Germain (1997) foresaw the structural imbalance between public authority and private financial intermediaries, in which public authority surrendered regulatory powers to private financial capital (market forces). The “transnational financial network” or “international financial community” gradually coalesced around converged consensus and exercised great competitive and emulative pressures for other countries to follow. The distinction between “Anglo-American” and “Rhenish” models of finance has been blurred as the latter category of countries involves more in transaction-oriented capital markets. Worse still, governments with piling national debts become increasingly dependent on the willingness of private financial actors to purchase and hold public bonds and securities. The reliance on private markets to fund government debt has further deepened the dilemma of regulatory capture.

The nexus of public-private collaboration in financial governance has been euphemized as “network governance” of a new regulatory shift (Mosley, 2009b). The problem is that public authority subsides with the rise of transnational alliance of private financial interests, and the financial game turns too complicated for prudential supervision impossible. The private financial sector has been actively involved in the formulation of universalized standards within various club organizations and with IMF and World Bank. The U.S.-based credit-rating agencies, notable known Moody's, and Standard & Poor's (S&P), have immense powers on rating for soundness of sovereign states and private institutions (Sinclair, 1994). The complex structured financial products depend on risk weighting that is tied to credit ratings. If credit ratings agencies get it wrong, the self-regulated risk weights for the liquidity requirements are miscalculated. Ironically, some of the troubled financial institutions in this crisis have been rated inaccurately, which fundamentally undermined the credibility of the current regulatory basis.

This is why the 2007-08 financial crisis, with its epicenter in the US, is believed to cast a devastating blow not merely to the credibility of financial institutions of all types, but also to credibility of US risk management and distribution. It is outrageous for government regulators to rely on "value-at-risk" (VAR) models used by institutional investors to work out themselves how much capital they should set aside as insurance against losses on risky assets, according to the Basel II Accord (Tarullo, 2008; The Economist, July 18th 2009: 61). Indulging rapacious financial interests for self-governance illustrates how regulatory capture by the network of private financial institutions could be a catastrophe. The consequences may be summarized as "socialization of risks, privatization of benefits." The moral hazard problem is sequentially ushered in the process of financial restructuring. Particularly constrained by the faith in neoliberal capitalism, US government pours into huge public money, gauges cost distribution between shareholders, bank creditors and taxpayers, but refuses to nationalize those giant financial institutions. Driven by market-type incentives, U.S. government gives up on the golden window of opportunity to clean up problematic financial institutions and render bankers an effective veto power over financial policy (Johnson, 2009b). Only with the ideological disenchantment from neoliberal capitalism could the state-market imbalance be remedied and the global financial architecture be overhauled.

IV. U.S. Regulatory Reform in the Wake of Crisis

The crisis of this scale quietly alters the power structure of global economic governance. The club-like international organizations (G7, IMF and FSF) acknowledge their credibility and legitimacy crises, thus incorporate more participation from developing countries. In the wake of the crisis, the ascendance of G20, the reallocation of IMF voting quotas (US lost its veto status with China's quota increase), and the transformation of Financial Stability Forum (FSF) into Financial Stability Board (FSB) to include China, India, Korea and Indonesian all illuminate the underlying power shifts. It is worth observing whether the power shifts affect the existing neoliberal global governance. But, for the time being, the most pressing issue for global financial governance is to observe how American authority conducts a regulatory overhaul to tackle the underlying problems in financial industry. And, once the reform steps are made forward, how the new regulatory practice in the United States turn into an international agreement?

The underlying problems of the 2008 financial crisis revealed could be summarized as follows: first, the "too big to fall" problems of large financial (including non-bank) institutions need to be redressed. The large banking and financial holding companies have posed the "moral hazard" problem of "too big to fall." One way to tackle this problem is to place a size cap on it. Another approach under which the U.S. Congress favors is to require these institutions via a higher capital adequacy standard and quantitative minimum holding of liquidity. Second, the "self-regulation" approach of the Basel II should be overhauled with more government intervention. The rebirth of government regulation comes back. The "Volcker rule" that is advocated by former Fed chairman and the current administration's economic advisor, Paul Volcker, set out government restrictions on excessive risky activities and proprietary trading activities, not really done for clients. Third, the conflict of interests for credit rating agencies should be emphasized. New regulations consider to hold credit rating agencies legally responsible for their credit assessments. Forth, customer protection agency will be set up to stop abuses on financial products.

Simon Johnson, in his testimony before Joint Economic Committee in the U.S. Congress on October 29, 2009, points out: if America wishes to maintain its global political and economic leadership, despite the rise of Asia, it is urgent to revise its policy stance toward the financial sector, which means largest banks to be broken up, "excess risk taking" to be taxed, and nontransparent interconnectedness among financial institutions of all types to be reduced as well (Johnson, 2009a). Fred Bergsten also points out, the "overleveraging finance and under-pricing of risk"—especially in the United States manifest that systemic inadequacy of global financial regulation. An international consensus on the key issues such as capital requirements, liquidity and leverage ratios, resolution authorities, and compensation practices is the most urgent (Bergsten, 2009). These proposals of reforms attest that the structural roots of the 2008 crisis lie on excessive liberalization and securitization of financial capital beyond sound and systemic regulation. The domestic foundation of embedded neoliberalism has been put in jeopardy, not only in the United States, but in some other European counterparts.

As the U.S. Senate is in the process of putting forth a new regulatory bill, it appears that the outrage from the public toward the financial community and the upcoming election in November have provided great momentum for substantial reform to move forth. Economic advisors have also repeated the necessity to turn the domestic reform into a new agreement of financial governance. It is important for the U.S. government to harmonize the new rules among peer countries in order to avoid competitive disadvantage for its own financial industry. How the European Union and other G20 countries react will be of great importance for the future of global financial reform.

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