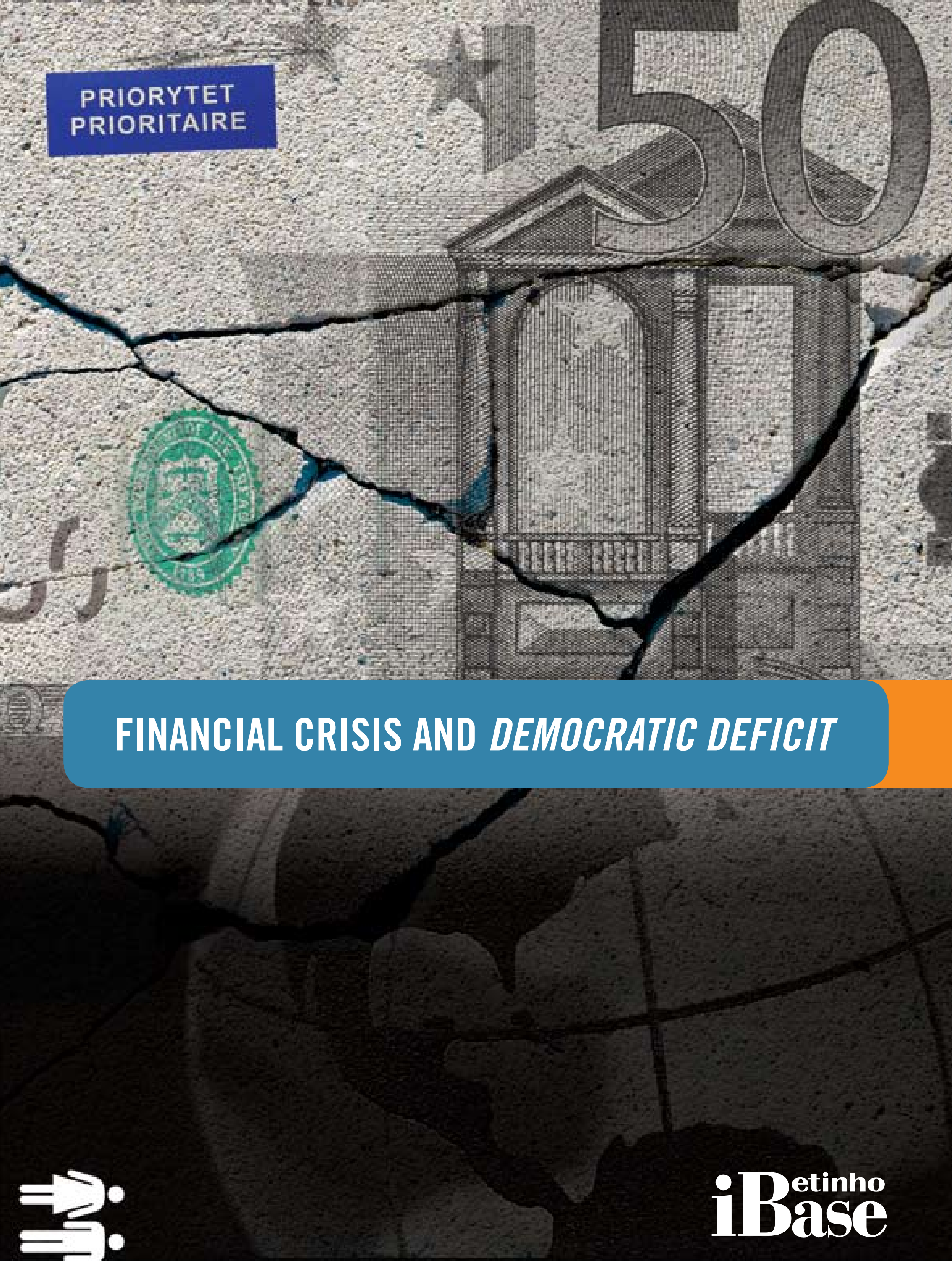

FINANCIAL CRISIS AND *DEMOCRATIC DEFICIT*

iBase Betinho

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Financial crisis and *democratic deficit*

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: Summary


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: Presentation

This is the second volume of the initiative *Financial liberalization and global governance: the role of international entities*, initiated in July 2006. Coordinated by IBASE and funded by the Ford Foundation, this initiative is developed in partnership with specialists and activists from 13 countries.

Its objective is to study the *democratic deficit* in the operation of international financial institutions and propose alternatives to overcome it. It is an initiative that provides instruments to social organizations and movements, parliamentarians, developing country governments, among others, to help them in their political struggles to have voice and influence in the institutions that decide on regulations to be followed by financial institutions around the world.

Those decisions have a profound and direct impact on people's lives and well-being. In addition, they restrict the choice of public policies, especially for developing country governments, which have none or very little participation in the decision-making process of those institutions.

The first volume – *Who rules the financial system?* – dealt with the *democratic deficit* in the international institutions that formulate financial regulation strategies. The nature of their decision-making processes was analyzed, and their importance and the impact of their work were clarified. The operations of institutions that are not well-known by the public in general, but that are central for banking regulation, such as the Basle Committee, received special attention.

In this new booklet we discuss the failure of the regulatory system that generated the current crisis. The magnitude of this crisis has led developed country governments to drastically intervene in markets and financial institutions – something unimaginable just a few months ago.

There is a brief description of the financial processes that led to the current crisis, an analysis of the regulatory failures in this process, and how civil society organizations can address these issues. Some alternatives to overcome the *democratic deficit* in the operation of entities, such as the Basle Committee, are discussed. This is a crucial task in achieving a more democratic international financial governance.

This is a unique moment to promote change and social movements and organizations should explore this opportunity. The purpose of this initiative is to help in the development of analytical capacity amongst activists and leaders of civil society movements and organizations, thus strengthening their criticism and political action against neoliberal financial globalization.

The coordinators, Fernando Cardim de Carvalho and Jan Kregel, produced this text based on information from the work developed by the initiative's participants, as well as discussions held in two workshops. However, the coordinators hold final responsibility for the text. The analyses produced by the other participants are available at the Ibase portal <www.ibase.br>.

: Introduction
Financial crisis, regulatory failure and the *democratic deficit*

No matter how the year 2008 finishes it will be remembered as the year of the world's most severe episode of the deepest financial panic since the great depression of the 1930s. In fact, it is the common, publicly expressed opinion amongst economic analysts, government officials, bankers, financiers, and politicians that the financial crisis of 2008 was only the beginning of another Great Depression. As a result governments in many countries, including the US, the UK and Western Europe, Latin America and Asia, have announced a series of direct government intervention, including measures that were unthinkable until recently, such as the large-scale nationalization of financial institutions and large government expenditure packages.

The immediate causes of the crisis are well-known. As the real estate boom progressed, an increasing number of mortgage loans were made with adjustable rate repayment schedules to individuals who had insufficient incomes, lacked steady employment or wealth to guarantee repayment. These mortgages were pooled by a wide range of financial institutions including banks to form of asset-backed securities called collateralized mortgage obligations (CMOs) that were sold to investment funds, other financial institutions and institutional investors, in a process known as *securitization*. It was necessary for these assets to receive a rating from a nationally recognized credit rating agency of investment grade (above BBB+ or Baa3) in order to make them eligible for purchase by capital market institutions such as pension funds, whose investments are restricted to such assets.

On hindsight, one can ask how could the banks, the institutional investors, and the credit rating agencies all staffed by highly professional, highly-paid analysts have gotten things so wrong? There are many explanations, most of them consisting in variations of the same basic idea: massive regulation failure at every step of the mortgage securitization process, involving the entire financial system that created the opportunity for the first systemic crisis since the Great Depression.

If this "consensus" view is correct then the argument that representation in international institutions dealing with standards and codes in financial regulation should be restricted to a small number of "technical" experts from the countries in which regulation is most advanced may have suffered a fatal blow. As argued in a previous publication,[1] it is this argument that has led to the creation of international entities dealing with key financial regulation such as the Basel Committee where membership is highly restricted, excluding even some minor industrial economies, and all developing countries, including emerging economic powers such as the BRIC group (Brazil, Russia, India and China). Only G10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom andUnited States) are members of the Committee, even though the rules it formulates for banking regulation have been adopted by all countries. This creates a blatant *democratic deficit* that is commonly justified as being necessary to allow more focused debates which lead to more efficient and technically superior conclusions. Implicit in the argument is the idea that regulators from G 10 countries are better prepared to deal with the sophisticated practices of advanced financial institutions that operate in the most developed economies and operate around the globe. It is argued that allowing other countries' representatives to participate would only detract from the efficiency of the debates since the Committee's members are supposed to be familiar with state-of-art financial practices and devise methods to contain their risks, while regulators from other countries would lack such experience and expertise.

[1] CARVALHO, Fernando J. Cardim de; KREGEL, Jan Allen. *Who Rules the Financial System?*, Ibase, Rio de Janeiro, June 2007.<http://www.ibase.br/userimages/who_rules_the_financial_system.pdf>

The current crisis has spectacularly demolished this argument. The crisis began in the United States, home of both the most sophisticated financial institutions and markets and the supposedly best prepared and most experienced financial regulators in the world. Through contagion the crisis has extended to Western European banks, in particular in the UK, where one would expect to find perhaps the second best financial regulators in the world. Emerging economies are also suffering the impact of a crisis that was not of their own creation and had nothing to do with financial practices and procedures or with regulation failures occurring in those countries. The most notorious imbalances and vulnerability factors were actually accumulated right under the view of what were assumed to be state of the art regulations administered by regulators that today declare themselves perplexed at the greed of financial institutions!

The *democratic deficit* of international regulatory entities such as the Basel Committee didn't make the world economy safer and more stable. In fact, the list of shortcomings in the financial rules of behavior proposed by such entities is long and will be summarized below. The extent of the failure of these entities in fulfilling their self-attributed role is in fact so overwhelming that one cannot really expect other countries to orient their behavior according to rules that so obviously failed to generate systemic stability.

In the rest of this pamphlet we will highlight the main regulatory failures that allowed the current crisis to emerge and grow to a point where desperate measures ended up being adopted by governments of developed countries trying to avoid panic and an economic depression. In the next section, we will present a very compact description of the financial market processes that engendered the current crisis. Next, we explore the sequence of regulatory failings that marked theses processes. We follow this discussion to a summary examination of whether the situation would be better had the world already implemented regulatory strategies such as the one proposed in the Basel II agreement. Finally, we take up the problem of how civil society organizations could tackle these problems and why it is more crucial than ever that the *democratic deficit* that marks the operation of such entities like the Basel Committee be overcome.

: The crisis

The roots of the current crisis are to be found in the broad-based support for financial liberalization that led to substantial deregulation of domestic financial markets in the 1980s.This was paralleled by the movement towards liberalization in economic policies applied in developing countries now known as the "Washington Consensus". The movement was based on the idea that reducing government involvement in the real economy should be accompanied by an increased role of market incentives in finance. It was argued that the then existing financial regulations were too tight and too protective of existing institutions, choking innovation and keeping the cost of capital too high for borrowers. Directed interest rates and rate controls were baptized "financial repression" and were blamed for keeping private savings too low relative to the needs of capital accumulation, growth and prosperity.

The promise of financial liberalization was to launch a new era of rising investment and high growth rates for all. In addition, there was a strong ideological component in the movement, which relied on the belief that markets would always know better than governments. When the current financial crisis suggested that they did not, it led some early champions of financial liberalization, such as former Fed Chairman Alan Greenspan, to admit to being "in a state of shocked disbelief."[2]

The impact of financial liberalization on developed and developing economies was wide and deep. One of its central aspects was the dis-

[2] Testimony of Alan Greenspan at the hearings on The Financial Crisis and the Role of Federal Regulators, Thursday, October 23, 2008, House of Representatives, Committee on Oversight and Government Reform, Washington, D.C., lines 385-6 and 394-399 of the unofficial stenographic report.

mantling of barriers that separated and protected specific segments of financial markets, like the commercial banking sector and the securities trading activities. This was a two-edged measure: on the one hand, it opened new opportunities to financial institutions that were previously confined to specific financial operations to explore other lines of business; on the other, it created or increased competitive pressures on institutions that had traditionally counted on the protective barriers to competition created by regulation. Thus, more aggressive financial institutions tried to take advantage of more profitable lines of business, often by developing financial innovations that allowed them to engage directly the entities that originally occupied these segments. The other institutions were forced to change in order to hold their ground against the attacks of aggressive competitors.

The pressure to increase profitability in the newly liberalized financial environment led to a widespread consolidation movement in the system, in which laggard financial institutions were swallowed by the more aggressive competitors. Consolidation, however, was not enough to raise profitability, particularly in the 1990s. This period ushered in a new type of financial crisis, linked to the reversal of capital flows, rather than disequilibrium on current accounts, and largely confined to developing countries. None of them posed any significant threat to industrial economies, with the possible exception of the Russian crisis of 1998. The US economy grew in a reasonably sustained fashion for the whole decade, while Western Europe crawled and Japan dived into a semi-depressive state.

A remarkable feature of the international macroeconomic environment of the late 1980s and the 1990s was the dramatic reduction in the volatility of macroeconomic variables and in particular of inflation rates both in developed and in developing countries that has come to be known as the "Great Moderation". The "New Consensus" on monetary policy that has been thought to have been the cause of this improved performance led central banks, especially in the United States, to reduce basic interest rates even as output growth and unemployment achieved rates that had previously been considered as unsustainable. In an environment of overall stability, low basic interest rates translated into rather low longer term interest rates.

The picture for financial institutions thus in the 1990s was a rather complex combination of strong competitive pressures to increase profits and take an aggressive stand (even if for defensive reasons) against competitors and an overall environment of relatively low interest rates, at least in the traditional lines of business for banks, investment banks, and so on.

The way to reconcile both sides of the equation was to seek new markets with higher returns than could be earned in their traditional operations. Loans to emerging economies, junk bonds, and internet companies in the dot com boom had already been exploited to increase returns, but eventually produced substantial market dislocation. Thus, as conditions recovered after the collapse of the equity markets in 2000 financial markets pursued another alternative: mortgage lending that created a sustained boom in residential property prices.

The problem deepens

As the boom progressed, it became more difficult to find traditional prime borrowers and institutions thus sought additional markets, lending to borrowers who had been excluded from traditional lending by regulations imposed by government sponsored entities such as Freddie Mac and Fannie Mae. The exclusion, however, was justified since these unsatisfied borrowers were those who held no jobs, had no dependable sources of income or assets to offer as guarantee. The mortgages to such borrowers are considered to be subprime since they do not "conform" to the conditions set down for guarantees by the GSEs (Government Sponsored Enterprises). Such contracts were called *subprime*.[3] In addition, the GSEs set maximum limits on the size of the mortgage that was considered conforming, so "jumbo" mortgages above this maximum where extended to Alt-A, borrowers.

[3] Of course, this does not mean that these persons should not have access to loans to acquire their houses. It does mean that profit-maximizing private financial intermediaries had a good reason not to be interested in supplying them. Giving access to decent housing to the poor should be a priority for governments, a matter of public policy.

RISKY BUSINESS

Residential mortgage contracts are long-term contracts in which the house itself is held as collateral for the debt. The buyer does not become owner of the house until the debt is fully settled. In case of a default by the borrower, the lender simply repossesses the house. Repossessing a house, however, although better than losing the loan, is not, of course, what the lending bank wants. While holding the house, the bank loses interest income. It also has to bear the expenses of resale. If the market is depressed, as it is now, this may take some time, so the bank will have to face the choice between selling the house at a loss or conserving it at the costs of maintenance to avoid its deterioration.

For all these reasons, before conceding a loan it was important for banks to assess the credit worthiness of the borrowers. While many subprime borrowers were good credit risks, as the boom proceeded loan originators used fraudulent practices to induce borrowers who were not qualified to apply for loans and to misrepresent their economic condition to allow them to qualify in order to earn income from increasing the volume of lending. Thus, there was an incentive to increase this type of lending because banks could charge higher interest rates since it was classified as more risky, although in a housing market where everyone believed the price of houses could only go up it was assumed that the borrower could always sell the house at some profit, and repay the lender.

To exploit this activity new practices and instruments had to be created. In the jargon of economists, *financial innovations* had to be introduced to make these operations feasible. Of course, financial innovations are not only means to exploit new market possibilities but also a way to circumvent regulations and supervisors' oversight.

The first major innovation was the dissemination of the use of statistical models in the analysis of credit, in place of the individual research that was done in the past. Quantitative credit scoring models, for instance, allowed the risk of a credit applicant to be analyzed according to the characteristics of the group to which he or she belonged rather than by his or her individual characteristics.

Thus, a person of a certain age, ethnicity, professional group, etc, had her risk evaluated by the average of persons in the group with the same traits. Of course, this reduced the costs of credit assessment for the bank but it also meant that each person would be judged by a group average. Besides, these averages change over time, so whatever might be considered an appropriate value of the index at a certain moment of time could become obsolete at a later date. Repayment averages are certainly different if they are calculated during good times and in bad times, for instance. Data obtained during the relatively good 1990s would be misleading if used to calculate probabilities of repayment in the turbulent mid-2000s.

The second innovation, however, allowed these concerns to be overlooked. That was *securitization*. Securitization basically means the transformation of credit operations between a bank and a borrower into an operation in which securities issued in capital markets are used to fund lending to a large amalgam of similar borrowers. Securitization has been practiced since the 1980s, and was the principle used in the creation of Brady bonds that allowed developing countries to repay their creditors.

Securitization has been used successfully in the sale of pools of credit card receivables, auto loans, immigrant remittances, and even consumer loans. For banks, the process allows them to earn income from originating the loans that are securitized, and it means that they do not have to hold capital to support the lending because it leaves the bank's balance sheet when it is sold to capital market investors. This incentive was increased by the implementation of the first Basle[4] risk weighted capital adequacy regulations since these assets carry a 100 per cent weighting. For borrowers they are attractive since they offer a higher return than traditional capital market assets. There are a lot of these investors around: institutional investors, like hedge funds[5], pen-

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[4] ON this theme, see CARVALHO, Fernando J. Cardim de; KREGEL, Jan Allen *Who Rules the Financial System?*, Ibase, Rio de Janeiro, June 2007.

[5] They are common funds using private assets and investing in negotiable instruments (securities and derivatives). They can use leverage in several ways, including short positions, and are generally unregulated. These funds are supposed to have highly sophisticated and risky investment strategies.

sion funds, investment funds, money market funds, insurance companies, but also financial institutions such as banks, investment banks, and wealthy individuals who are driven by the search for higher returns.

Securitization had been practiced by the above-mentioned GSE since the late 1970s with success. However, the extension of the practice to subprime lending proved to be the downfall of the financial system.

One important feature of the securitization process to mortgage lending is that it makes it more difficult to evaluate the credit conditions of the underlying mortgage holders. As a result, investors have tended to rely almost exclusively on the assessments of credit rating agencies who appear to have been no better equipped to evaluate the risk of default on these packages of securitized mortgages. Yet, the whole concept of securitization was based on the efficient evaluation of idiosyncratic risk by either the originator of the securities or by the credit rating agencies. But, the incentives underlying this business were not inductive to efficiency in this area. As already suggested, all those involved in the creation of these assets were rewarded by maximizing the volume rather than the quality of the mortgages, while the credit rating agencies income was determined by the originators, and thus was also maximized

Another interesting "innovation" was the use of adjustable-rate mortgages, in which below market interest rates were applied in the first two or three years of contract, but would be reset to market rates thereafter. Borrowers who would not normally expect to be able to borrow would thus be lured into accepting a mortgage by the below market interest charge. Often these contracts were presented as fixed rate mortgages, with the specification of the reset to a new fixed rate, and the reset costs were hidden in the text of long and complicated legal language.

However, independently of the fraudulent activity and the inattention to small print it is important to remember that all of these transactions took place in an environment in which prevailed an unshakeable belief that house prices would keep rising forever. Thus the worst case scenario in the case of a default on the mortgage by the borrower the house could be sold at a profit and whether the borrower or the lender would be able to earn a capital gain.

However, as interest rates began to rise as the Fed started to "normalize" interest rates, and some of the adjustable rate mortgages started to reset, the rate of delinquency on monthly mortgage payments started to rise. At the same time the rate of increase in house prices started to decelerate. The consequent reduction of interest revenues affected the returns on securitized mortgage assets. It thus became more difficult to place these securities in capital markets and banks found it necessary to keep increasing numbers on their own books. This reduced the generation of new mortgages, and further decelerated the rate of increase in house prices. When banks started to report losses on their holdings of these securities due to the requirement that they mark their assets to market value, other capital market investors started to question the reliability of the credit ratings on their holdings.

As further defaults developed credit rating agencies started to downgrade the securities and some investors who were limited to investment grade securities were forced to sell into a falling market. Most securitized structures were insured by bond guarantee institutions known as monocline insurers. The downgrades required these firms to provide additional collateral for these guarantees, and as a result their own credit ratings were called into question, producing a further downgrade in the assets. An embryonic credit crisis was thus transformed into a liquidity crisis, and some firms were forced to declare bankruptcy as the value of their securitized assets fell below the value of liabilities. The inability of these firms to make payments to other firms placed them in financial difficulty and set the stage for a classic debt deflation in which the attempt to liquidate assets drove down prices and increased outstanding indebtedness. A financial crisis is then out in the open.

: Regulation failures

The crisis provides a vivid illustration of the flaws in the regulatory strategy adopted to support financial liberalization. In simple terms it was flawed because it relied on a false assumption, voiced by Greenspan in his testimony quoted above, that financial systems would be naturally stable because institutions would provide self-regulation as the result of "the self-interest of lending institutions" to "protect shareholder's equity".

According to Greenspan, "The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations (undeniably the original source of crisis) would have been far smaller and defaults according far fewer. But subprime mortgages pooled and sold as securities became subject to explosive demand from investors around the world." Thus it was the firms that securitized the mortgages that were the basic cause of difficulty, supported by demand from final investors. Greenspan continues: "the consequent surge in global demand for US subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem."[6]

It is characteristic of this faulty assumption that almost all the institutions Greenspan lists in his comments are regulated, with the major exception of purchases of the securitized assets by hedge funds. Investment banks are not identified by name, but they are also included under the name "securitizers". The problem, of course, is that, as Greenspan

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[6] See footnote 2.

admitted, the regulators seemed to think that financial markets are naturally stable, that speculation is fundamentally harmless, just one of the pieces of an efficient modern financial system.

Regulators failed when they overlooked that layering of risks involved in the issuance of securities which relied on pools of subprime mortgages. They failed again when they allowed the creation of ghost financial institutions variable interest entities such as Specialized Investment Vehicles, etc, to take financial assets off financial institutions balance sheets to give them a safe habour out of the sight of financial supervisors. Not surprisingly, they failed when they let credit rating agencies not only use rating classifications, such as the famous triple AAA and other investment grade classification, originally designed for corporate and local government securities,for collateralized mortgage securities.

And regulators failed again when they let these same agencies interact with securitizers in order to design securitized structures that they could give high ratings, instead of maintaining a position of honest neutrality as a condition for the transparency of their assessments. In fact, regulators failed in practically every single step of the process of accumulation of imbalances and shady practices that ultimately led to the financial crisis that is already costing jobs and income for practically all people in the whole world.

The big question, of course, is *how could they fail so extensively?*

First, the most important aspect of these failures is the fact that they didn't take place in the developing countries that are not considered trustworthy to take part in such technically highly prepared forums such as the Basle Committee. In fact, the crisis began, and is particularly virulent, in the United States and has spread more intensely to the UK and Western Europe, and then by contagion to Latin America and Asia. So much for the argument justifying the *democratic deficit* that restricting membership in the Basle Committee to the expert representatives of the G10 increases its efficiency! Not only these closed clubs have not been capable of devising rules that could work for the benefit of a large number of countries, they were not even capable of working out rules for their own benefit! However, all countries will pay the price for the failure of developed country regulators to devise efficient rules to ensure systemic stability.

Moreover, financial supervisors are usually fragmented as a result of a historical process that has determined their structure as a response to particular aspects of each crisis, or at least in their approach to their mission. Pursuit of profit led financial institutions to seek methods to profitably exploit the large number of black holes still existing in supervisory apparatuses, promoting deals between banks, investment banks and brokers, and insurance companies, which are regulated by different entities or according to different rules. Even worse, dealings with hedge funds or even ghost entities, such as variable interest entities such as SIVs, allowed regulated financial institutions to simulate risk transfers designed mainly to mislead financial supervisors.

Of course, the main problem is not really one of competence. As Greenspan's words above show very well, the problem is that regulators in developed countries have shared a mistaken assumption about how capitalist systems work and, in particular, about the systemic properties of the advanced financial systems that operate in those economies.

Regulators, as much as pure ideologues, simply bet on the view that capitalist economies are stable except for the eventual occurrence of large shocks, "tsunamis", which, much like natural disasters, cannot be avoided by any type of regulation. Regulators should not stifle financial innovations, because this would only prevent progress and keep the cost of capital higher than it should be. The invisible hand should be enough, as Greenspan expected, to guarantee that excesses would not happen. Markets would operate efficiently, except for the unfortunate shocks that happen from time to time. Regulators had to make sure that financial systems could count on protective cushions to absorb these shocks, although some of them could be so strong that one could only resign oneself to suffer their impact.

Of course, it was not just a question of ideology. Financial institutions, investors, speculators, all profited from the rapid expansion of financial markets in the 1990s, which actually expanded much faster than the productive sectors, which in itself should have caused some concern.

It is very difficult to try to disentangle the specific influences of ideology and self-interest. The closed world in which financial regulators live is most of the time populated by both types, in interchangeable positions. Regulators, central bankers and financial business executives frequently live in promiscuity, which in itself could not be so serious a problem were members of other social groups invited to take an effective role in their meetings.

What was particularly damaging was the fact that they all shared the same view of financial systems as being stable, and of regulation as a (costly) nuisance, which is a central element of what is called the *neo-liberal* view of the dynamics of capitalist economies. Basel II is, in fact, the crowning achievement of this approach. The agreement takes what the Committee saw as the "best practices" developed by private banks to measure and manage risks and made them a paradigm to be followed by every banking institution. That these practices are at the heart of the failed methods with which banks dealt with the risks that accumulated to the extent that they laid the groundwork for the current crisis shows the inherent errors in adopting the failed strategy proposed by the Committee. The current crisis signals the failure of Basel II even before its worldwide adoption.

BASLE II GENERAL FEATURES

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

Supervisors are supposed to perform many more functions in the new system than in the past. They are supposed to evaluate the risk measurement and management systems, to assess the adequacy of banks' administrative structures in implementing their stated risk strategies, and to develop specific ways to deal with risks not explicitly treated in the new Accord, such as liquidity risks.Finally, the third pillar, market discipline, lists the kinds of information banks that are required to disclose in order to allow markets to make their own evaluation of their risks.

Opening up the institutions that set financial regulation to a larger membership should increase the probability that other voices, other interpretations would be heard. In particular, given the damages the current crisis is causing all over the world, in the form of lost jobs, lost output, lost pensions, lost savings, etc, other views about the operation of financial systems and their role in capitalist economies should be heard and considered. The first reactions to the crisis, however, have not been promising in this respect.

: Official reactions to the crisis

As one would expect, perhaps, after the initial panic, regulators, financial executives and a large number of authorities in the United States, the United Kingdom and Western Europe seem to have been converging toward the view that relatively marginal adjustments in the regulatory strategy pursued so far should be enough to strengthen the financial system and prevent other crises in the future.

Of course, the point has been hammered home most insistently by President Bush, who has repeatedly reaffirmed old slogans such as that regulation should not stifle innovation, etc. Much more important, though, than the outgoing president's political preferences are the positions that will be advanced by President-elect Obama on these matters. However, although the newly elected president has declared more than once his disposition to promote activist fiscal policies to overcome the crisis and control its effects, the new administration's stand on the question of financial regulation is much less transparent.

So far, the most important public initiative by authorities to examine the responsibilities of financial regulators and supervisors in the generation of the current crisis has been the G20 meeting in Washington DC, in November 15, 2008. As demonstrated in the long communiqué made public at the end of the meeting, the prevalent view among governments is the validity of the liberalizing path followed so far; some adjustments devised to improve methods of supervision might be necessary, but there is no necessity to change them in any important way.

These adjustments are reported in five headings: 1. strengthening transparency and accountability; 2. enhancing sound regulation; 3. promoting integrity in financial markets; 4. reinforcing international cooperation; and 5. reforming international financial institutions.[7]

Under the first heading, the G20 supports reliance on the so-called best practices of risk management, with some improvement in the way information is collected and distributed, to particularly with respect to off-balance sheet data, which can follow the traditional path of reporting in the form of footnotes. Thus, as before, the G20 will keep the reliance on private risk management as the main pillar of systemic stability.

The same trend is present under the second heading, where concern is expressed over the performance of credit rating agencies, but it is made clear that governments are not ready to abandon their reliance on such entities. A few additional concerns are listed with the "systemically-important institutions" that are not yet subject to any kind of regulation, even though the opposition of the US government to extending regulation to entities such as hedge funds is well known.

The same heading 2 makes it clear that "banks' risk management practices" remain the main pillar of their regulatory strategy, recommending that attention should be given to ways to strengthen these practices. The Basel Committee is supposed to remain the main forum of debates for rule-setting in banking supervision, and is charged with the mission to examine new forms of stress testing to examine the efficacy of banks' internal models of risk measurement.

Finally, under heading 5, a call to an undefined expansion of membership in the Financial Stability Forum[8] is made. In fact, under this heading, and, indeed in the whole communiqué, the G20 reaffirms the legitimacy of the existing entities, including the informal clubs like the Basel Committee and the FSF, to lead the process of search for improvements in the existing body of regulation. The presence of Argentina, Brazil, China, Mexico and other developing countries did not make

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[7] The White House, President George W. Bush, Office of the Press Secretary, Declaration of the Summit on Financial Markets and the World Economy, November 15, 2008. <http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html>

[8] The Financial Stability Forum (FSF) was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.

the slightest difference, it seems, to change the focus of the debate to consider other possible regulatory strategies or the national autonomy to pursue independent ways. The G20 reaffirmed the "commitment to an open global economy" and accepted that "our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace." (paragraph 8)

G20: WHO ARE THEY?

The new Group of Twenty (G20) forum of finance ministers and central bank governors was formally created at the September 25, 1999, meeting of the G7 Finance Ministers. It was created "as a new mechanism for informal dialogue in the framework of the Bretton Woods institutional system, to broaden the dialogue on key economic and financial policy issues among systemically significant economies and to promote cooperation to achieve stable and sustainable world growth that benefits all"[9]. To launch the G20 at its first ministerial meeting in Berlin in December 1999, the G7 finance ministers were to invite "counterparts from a number of systemically important countries from regions around the world," as well as representatives of the EU, IMF and World Bank.

The formal birth of the G20 can be traced to the G7 Statement at their Cologne Summit on June 18, 1999. The G20, from this initial formulation as the "GX" to its September 1999 birth, succeeded the earlier G22, created at President Clinton's initiative at the November 1997 APEC leaders' meeting. The G20 includes the G7 countries, and eleven other countries (including G8 member Russia). The members of the current G-20 are the finance ministers and central bank governors of

[9] G-7. "Statement of G7 finance ministers and Central Bank governors". Washington, DC, 25 sept. 1999. <http://www.g7.utoronto.ca/finance/fm992509state.htm>.

19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States of America. The European Union is also a member, represented by the rotating Council presidency and the European Central Bank. To ensure global economic fora and institutions work together, the Managing Director of the International Monetary Fund (IMF) and the World Bank President, plus the chairs of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank, also participate in G20 meetings on an *ex-officio* basis.

It is important, moreover, to notice that it is not just that the G20 seemed to simply stamp the same kind of rhetoric and strategic vision held by developed countries, but that the legitimacy of the G20 to serve as the forum to this kind of discussion should be examined. Of course, membership in the G20 is larger than in the G8, but does it have any mandate from the other (more than 160) countries not invited to the debates? It is possible that a meeting of 180 countries (membership in the IMF is a little over 180) would not be able to produce a result, but did this meeting produce anything more substantial? And in whose name do these countries speak? Are they there on their own behalf or are they representing other countries?

Thus, it is hard to consider the November meeting of the G20 as anything other than a political gathering led by an increasingly powerless and irrelevant outgoing political leader to give the impression that action is being taken or planned. It didn't represent a real attack on the *democratic deficit* that is characteristic of international financial institutions dealing with financial regulation nor it signals any serious questioning of the regulatory practices and strategies that led to the worst crisis since the 1930s.

The Alternatives: Some Fundamental Principles

What is at stake in this debate? Fundamentally, there are two views about the way financial systems work in modern capitalist economies. On the one hand, neoliberals think that private markets are stable and efficient, and that private agents know best. In this view, regulation not only does not adequately protect the economy from financial crises it tends to cause them to be more frequent and more serious, since regulation (and its twin sister, the safety net) is believed to distort perceptions of risk and the incentives to control it. The neoliberal dominance of the last twenty to thirty years led to de-regulation and financial liberalization, to the refusal to bring under control systemically important but highly speculative entities such as variable interest entities, to the lax attitude with respect to increasing addiction to gambling that became a feature of the whole financial sector in the US and Europe, and is ultimately responsible for the deepest crisis capitalist economies have known since the 1930s.

But neoliberals are unrepentant. After a moment's perplexity, as exhibited by luminaries of this approach like Alan Greenspan, they quickly regrouped in their strongholds, such as the Basel Committee and the Financial Stability Forum, to make sure that any change that may come in the future is confined to marginal "improvements" to the instruments they have devised in the past. Thus, it is not the privatization of financial regulation, represented not only by the attribution of regulatory authority to private firms, such as credit rating agencies, but, more importantly, by the whole strategy of relying on banks' own methods of self-regulatory risk measurement and management as instruments of prudential regulation to achieve systemic stability that is seen as the root cause of the current crisis.

Rather, the crisis is the result of bad luck, "excess greed", whatever this may mean, and a supervisory system in need of adjustment. Not of major changes, but of adjustments in the parameters of their policy models. Thus, the Financial Stability Forum proposes tighter rules of conduct to credit rating agencies, but not their disbarment. The Basel Committee considers raising capital coefficients besides perfecting the formulas used to calculate the coefficients to take account of liquidity problems, and so on. The system is good and can be bettered by adjusting nuts and bolts more tightly.

Critics of the neoliberal project hold very different views. Financial markets are particularly fertile ground for speculation, financial transactions are very opaque, and information asymmetry is strong making market manipulation relatively easy. More importantly, financial markets tend to generate and accumulate imbalances that eventually explode and cause serious problems for the whole economy. This is because of the strategic role of credit creation by banks based on their role in providing an essential transactions system in the form of bank deposits.

Financial institutions may contribute to full employment and growth, within certain parameters of systemic safety, but this requires efficient regulation and attentive supervision. Regulatory and supervisory authorities should always pay attention to the ways imbalances emerge and expand in financial operations inhibiting them before they cause real harm to the rest of the economy. To those who hold a critical view of the neoliberal project, the current crisis is the result of the accumulation of tensions and disequilibria that is expected to happen when financial markets are left free to choose their ways and the omission of regulators who thought their job was to free market forces in the sector.

Consequently, while proposals like those listed in the G20 communiqué issued after their November meeting at the White House mostly aim at making the casino safer for the *gamblers*, critics of this defence of neoliberalism aim at a complete reversal of strategies in the regulatory field.

For that to be possible, however, the *democratic deficit* in the operation of international regulatory institutions in the field of finance is a fundamental obstacle. To shape financial systems that serve the productive system, instead of subordinating it, support full employment and development, and preserve systemic stability should be the main goal of financial regulation. As the relevant institutions work today, the chances these objectives will be seriously considered are nil. Even an "expanded" FSF, as suggested by the G20, (nothing is said about an "expanded" Basel Committee, let alone a really representative Committee), would not allow a proper counterpoint to the views of financial executives and of the regulators that often share their views that dominate the regulatory apparatuses in developed countries. More radical alternatives have to be examined to allow for these other concerns, with the real economy, employment and development, to be seriously considered.

DEMOCRATIC REPRESENTATION

The first prerequisite for radical reform is the democratization of the international regulatory entities. To achieve it, it is necessary to shift them to the United Nations, the only forum where every country is fully represented according to the rule of "one country, one vote". This does not mean that everything has to be done in general assemblies, but it does mean that legitimate representation and definite mandates have to be decided in a general assembly where all nations have equal voice and representation. Double majorities, triple majorities, regional or group representation, there are many possibilities to make the whole process of reform more democratic. But it has to begin with universal, full participation. The G20 is better than the G8, which may have been better than the G3 or a G1. But one has to start from a G192 and the only place where this can be achieved is the UN.

To take radical proposals seriously into consideration, however, requires more than just identifying the purposes a rebuilt financial system should serve. It is important also to recognize that change has to be gradual and, in many cases, sequential. In other words, it is necessary to think strategically, differentiating goals that can be reached with relatively less effort and more rapidly than those which require more time to unfold. Thus, in official circles, over the next few months or even years there will be two parallel processes at work. One will seek measures and programs to mitigate the effects of the financial crisis and of the recession in real economy. This will take place on the national level, and in some cases on a regional basis. The other will seek the design of a new financial architecture. This multilateral process started November 15th in Washington and will go on for months if not years.[10]

Successful pursuit of meaningful reform will require that in both the short and the long term the measures that are taken are progressive, pro-

[10] The depth of the current crisis may guarantee the debate will last for years, in contrast with all the fuss that was made around the need for a "new financial architecture" in 1998, only to be forgotten when the world economy recovered soon afterwards.

tecting the population at large from the worst impacts of the crisis and contributing to the resumption of productive activities, but also increasing systemic stability and breaking the dominance of financial markets over production and employment decisions. In fact, we have to think in terms of two parallel processes taking place, one with immediate and the other with longer term objectives. The definition of immediate measures and programs to mitigate the effects of the financial crisis and the coming global recession must be accompanied by the longer-term objective of the design of new financial architecture. One should not be surprised by the conservative nature of the response to this challenge by official circles: bailouts for financial institutions and, perhaps, non-financial firms as well as the short-term, incremental adjustments in current regulatory strategies, as announced by the Basel Committee in a press release in November 20th.

While emergency measures need to be taken in the short term, it is important that these measures should restore systemic stability, not simply save bankers and speculators – the "speculator pays principle" should be the watch word – while carefully distinguishing between hedge funds, private equity funds[11], and other highly leveraged entities and those funds that actually gather the savings of the population at large, such as pension funds.

While the rescue measures should avoid rewarding executives for sinking their ships, the financial hardship that has been caused to those who were sold subprime loans on a fraudulent basis should be remedied just as any other case of fraud. Finally, bailout methods should be designed in such a way as to make sure that eventual profits that emerge from the provision of public funds are returned to the state and, thus, to society.

To maintain a strategic vision of the whole process, on the other hand, also means that reforms have to aim for a redesign of the financial liberalization process to ensure that it provides adequate financing to

[11] It is a specific type of investment fund. They buy shares of a company to remove it from the stock markets, thus "closing" its capital until they decide to sell it back to the public.

serve the needs for productive investment rather than providing for the dominance of financial over productive activities.

There is a wide variety of critical perspectives on the shortcomings of the neoliberal project leading to an also wide variety of reform proposals. A few common aspects, however, can be identified as essential in all or most of them.

First and foremost, of course, there is the concern with the proper performance by financial institutions and markets of the role of credit and liquidity provider to productive firms and consumers, to support productive activities and the circulation of goods and services. Financial services are mostly inputs, not final goods, and they should be made available as consumers and firms need them, at reasonable cost. This means that the supply of financial services should be tailored to fulfill the needs of firms and households and that financial innovations should be screened before their diffusion to guarantee that they really serve society's interests rather than serving the financial institutions' goals to evade regulation.

Financial markets and institutions should, thus, be functional to production and development needs, promoting inclusion and opening access to services and savings products to the population at large. This is not enough, though. It is also crucial that these functions are performed without putting society in danger of serious turbulences and crises. This means that regulation and supervision should be recognized for what they are: police work, to control destructive tendencies bred in the normal operation of financial markets. It is not a question of criminalizing financial activities. One should recognize, however, that some activities do pose special threats to society and thereby become the object of special attention and monitoring.[12]

To ensure that systemic stability is cared for, financial regulation should be extended to all segments of the system. Instruments such over-the-counter derivatives or entities such as variable interest entities, private equity and hedge funds should be assessed from the point of view

[12] As it happens, for instance, with the drug industry or with airline transportation, where similar concerns with safety demand regulation and careful supervision by the authorities.

of their impact on the overall macro stability of the system through macro-prudential regulation. Other financial institutions such as investment banks, where supervisors like the Securities Exchange Commissions only enforce integrity-of-market regulations, should be subject to both micro and macro prudential regulation. In fact, financial regulation and supervision should overcome its historical fragmentation (which survives even in those countries where supervisors are reunited in the same institution, such as the Financial Services Authority in the United Kingdom).

It is not only a matter of unifying bureaucracies, but of developing integrated views of the operation of financial markets on both the macro and the individual institution level in an era of rapid consolidation. Supervisors should control the extent and modalities in which leverage may be increased and financial fragility developed. It is not possible that leverage can be concealed simply by creating unregulated ghost entities to hide it from supervisors. On the contrary, supervisors must be given the power to request information and restrict behavior in all the segments of the financial system to rest assured that systemic safety is being properly taken into consideration.

One important point to keep in mind when devising proposals for regulatory reform after an era of almost unfettered free-market globalization is that, contrary to insistent rumors, the prominence of the Anglo-Saxon variety of capitalism did not prove all the other varieties wrong or unsustainable. In fact, Europe and, even more dramatically, Asia developed particular instances of capitalist social organizations that are deeply different from the model employed in the United States and the United Kingdom. A central point of contrast between these experiences resides precisely in the role reserved for the financial system in each country. The centralization of decision-making about financial regulation in international entities such as the Basel Committee threatened to homogenize these structures, and, in fact, did take large steps in this direction, but as the crisis erodes the prestige of the United States-type of financial organization the validity of other arrangements will probably be reasserted.

This should be good news especially to developing countries, which have been forced to adopt supervisory methods such as those created by the Basel Committee, but that may now recover some degree of autonomy in this matter. National autonomy in regulatory matters is ritually mentioned in paragraph 8 of the G20 communiqué, but all the concrete proposals that are contained in the document assume again that the main loci of decision-making will be again the same international entities as before.

DEVELOPMENT BANKS

The neoliberal wave that grew into a tsunami in Latin American developing countries during the 1980s led to either the privatization or the elimination of public development banks in most of them. When this was not politically feasible, neutralization was commonly obtained either by forcing them to specialize in the service of special segments, such as small firms, or needs, or, even more frequently by forcing them to operate according to private banking principles. A large value was put on the need for development banks to be "profitable and safe". In some cases, this was obtained by forcing them to follow Basel rules, like private banks. Development banks are important precisely because in developing countries there are many projects to be financed that are not privately profitable but socially useful because they have wider benefits, such as clean water and cheap energy generation. Others may be too risky for private banks to finance them, like those that involve the introduction of technical innovations. The demand that development banks operate like private banks is based solely on the idea that "markets know better" and if privatization is not politically acceptable for any reason, forcing them to act as if they were private banks may be better than nothing. A fundamental step in the fight against neoliberal policies and reforms is to recover the role of development banks, freed from regulatory constraints that, as the current crisis shows every day, don't even work for private banks.

Civil society in action

To offer a counterpoint to these developments, and to pressure governments of developing countries to present their own views and defend their own interests in this process, Civil Society Organizations must be prepared to identify and debate alternative organization models for the financial system that can supplant and take the place of the liberalized structure that has been put in place during the last twenty to thirty years.

There are three basic alternative models which could replace the current arrangements and which would fulfill the requirements we discussed above.

1. A drastically downsized financial system where credit and transaction services would be provided by public banks and private equity markets would be shut down. Speculation in the banking system would be prevented by the strict specification of their functions. In this approach, securities markets are considered to have created more problems than benefits, stimulating short-termism and excess leverage, and the manipulation of asset prices in secondary markets. As a source of capital for productive activities and investment, securities markets are considered inferior to banks since the latter is capable of more accurate credit analysis than mass investors.

2. A mixed financial system, where the banking sector would be taken over by the State, but securities markets and non-bank financial intermediaries would remain in private ownership, although closely regulated and supervised. Again, public ownership of the banking system would lighten the burden of regulators, since these institutions would operate in strict accordance with their pre-stated mission. Regulation of non-banking institutions and financial markets would be changed in such a way as to restore the authority and efficiency of regulations and their supervision.

3. The third model would preserve private ownership of banks and non-banking financial institutions as well as securities markets, but would drastically overhaul the regulatory and supervisory system. In particular, the current Basel strategy of prudential regulation based on microeconomic rules would be abandoned in favor of a macroeconomic, systemic approach to stability. The new regulatory strategy would in fact restore methods and goals focused on control of risks rather than measurement and management of risks as has been

the expressed goal of the Basel Committee. The role of supervisors should be containing risks rather than trying to measure what is by nature immeasurable by individual institutions, such as systemic risk. In this interpretation, systemic risks are thought to be created less by the behavior of individual institutions than by the interaction between them that allows leverage to grow to unsustainable levels. Supervisors should concern themselves less with will-o'-the-wisps, like the appropriate measure of risk that could serve to the efficient establishment of appropriate capital coefficients, going back to simpler and arguably more efficient practices, such as setting leverage ratios and liquidity ratios to cap the exposure of banks to risks.

These are three very different strategic proposals to deal with the large-scale regulation failure that resulted in the current financial crisis. The choice between them may depend on political and cultural preferences, legal factors, and even plain estimations of efficiency of each arrangement in each national context. All of them, however, share one fundamental feature that is restoring a prominent role to public entities in the control of the financial system to guarantee that it fulfills a constructive role in financing productive activities and consumption while preserving at the same type an acceptable degree of systemic stability.

REGULATORY AND SUPERVISORY METHODS

The Basel Committee of Bank Supervisors approach to risk represented a break with traditional methods of regulation and supervision. Traditional prudential financial regulation was based on a set of indicators based on the acronym CAMEL, representing capital, asset quality, management, earnings and liquidity. Standard ratios (except for the management element) compared to a peer group provided the metric for evaluation of the creditworthiness of a bank. However, regulators in different countries applied the various elements according to the characteristics of their domestic financial markets, creating different standards for banks operating across national borders.

The first 1988 Basel Accord thus sought a common standard which would create a common measure and a level international playing field for global banks. This measure was a common ratio of bank capital to risk-weighted bank assets, set at a minimum of 8 per cent. The weights assigned to bank assets were common for all banks and reflected the relative risks of different types of asset. Thus, short term sovereign debt of a developing country government was given a zero weight, which meant that a bank did not have to hold capital for funds invested in these assets, while business loans and mortgage loans had risk weights of 100 per cent, which meant that the bank had to hold 8 cents of capital for every dollar lent. Since bank capital has a cost determined by the return on alternative investments that the bank's owners could earn, the idea was to encourage banks to hold less risky assets on their balance sheets.

However, since the risk categories covered broad ranges of assets (a loan to the local bar would have the same risk weight as the mortgage on a church) banks sought to increase their returns by lending to the more risky borrowers within each class. Further, the simple existence of different risk classes created distortions in banks' allocation of capital that was driven by risk classifications rather than economic considerations. Thus, a Basel II revision was undertaken to provide more precise specifications of risk and to include other factors such as operations risks and allowing banks leeway to self-regulation through proprietary models of risk analysis. This approach tried to adopt risk-sensitive prudential methods to set numbers specific to the particular balance sheet profile of each bank as represented by its history.

The Basel II method of prudential regulation, based on the assumption that stability can be assured if relevant risks are appropriately measured by banks themselves, relies on a false idea: that better statistics about past adverse events can provide reliable quantitative indicators of safe operational strategies. This has turned out to be a mistake, as all banks had satisfactory capital ratios as they entered a period in which they were nearly all approaching insolvency. This suggests that it may be time to return to the more traditional evaluation of acceptable limits to banks' strategies based on examination and evaluation of the banks' balance sheet ratios.

Achieving change in financial regulation

There are at least two obstacles to be overcome to allow the debate on these alternatives (besides, of course, the ones advanced by entities such as the Basel Committee) to actually take place. First, the forums where they are supposed to be implemented should be either enlarged or replaced altogether. It does not make any sense that the reexamination of Basel II, for instance, be made by the same Committee that produced such a flawed approach to bank stability. The "technical" argument in favor of the discussion in *petit comité* has been completely delegitimized by the inability to prevent such a deep crisis to develop and by the fact that its cost is already being spread all over the world, which should have a say in any new plans that come in their way in the future. Besides, as it was pointed out in *Who rules the financial system?* (CARVALHO; KREGEL, 2008, p. 30-31), the deleterious impacts of Basel II on developing countries were visible much before its inadequacy for developed countries was demonstrated by the present crisis.

The second obstacle is the possible reluctance, particularly by developed countries, to recognize the right of each county to adopt regulatory strategies that serve their own interests, even if these strategies are divergent from a collectively preferred model. In fact, this may be the most important demand to be advanced by developing countries, because even if those entities are opened to a larger group of countries, there is no guarantee that they will seriously consider their needs. It has frequently happened that some voice is given to developing countries, only to disregard their demands or to pay lip service to them in diplomatic statements and communiqués that are not really intended to be implemented.

Be it as it may, one cannot give up insisting on the deficit of representation characteristic of entities such as the Basel Committee or the FSF. This is because even if membership in the Basel Committee was to be decided on strictly financial criteria, there would be no reason to include Sweden or even Switzerland, or even more scandalously Luxembourg, and exclude China, Brazil or South Korea. But, and one should be unequivocally clear on this point, it is not just a question of including this or that country, but of recognizing that this is a question of importance to all countries, rich and poor, developed and developing, so that voice and influence should be guaranteed to all.

The way ahead

Eliminating, or even significantly reducing, the *democratic deficit* in the international entities that assumed the responsibility for formulating rules of financial regulation is certainly a very difficult task. These institutions are usually insulated, protected by their developed country members that either prevent membership from being enlarged or sustain voting procedures that bias the result of any debate against developing countries.

The obstacles created to keep most countries out or without influence, however, were widely delegitimized by the massive regulatory failure that resulted from the deregulation strategies advanced by those entities since the 1980s. It is high time to either change their decision-making rules or to abandon them entirely, abandoning the neoliberal project of financial globalization and restoring a significant degree of autonomy for each country (including developed nations) to pursue their preferred strategies. The consideration of capital controls to give more choices to each country can no longer be excluded on principle, as it was in the heyday of neoliberalism.

CAPITAL CONTROLS

Is the name given to any instrument that serve to prevent or slow down entry and/or exit of financial capital to or from a given national economy. Capital mobility, that is, the ability of moving capital from an economy to another, gives wealth-holders the power to prevent even democratically-elected governments from adopting policies that are not in their benefit. In the absence of capital controls, wealth-holders can, for instance, oppose laws increasing taxes on higher income groups by simply taking their capital out of the country, using up its international reserves and causing balance of payments crisis. When Socialist President François Mitterrand introduced the wealth tax in France, in 1981, rich Frenchmen avoided paying the tax simply moving their capital out of the country. The dismantling of capital controls is called *capital account liberalization* (CAL). In the absence of such controls, central banks may be forced to keep domestic interest rates high to avoid capital flight, as it has been the case of Brazil after F.H. Cardoso dismantled existing capital controls.

Capital controls can exist under a large number of forms. They may be administrative controls, when, for instance, some operations are simply forbidden or subject to limits imposed by the government. They may be market controls, when a government imposes a tax on financial transactions across the border, making them more expensive (and thus less profitable). They may prevent entry of undesirable forms of capital, when speculative short term capital movements are denied entry. The bottom line is that capital account liberalization reduces the power of the state (and the society it represents) because it allows some citizens to escape its laws by simply moving their wealth away from the country, creating all sorts of balance of payments pressures in the process.

Such a process, on the other hand, does face enormous difficulties. On the one hand, institutions have forcefully resisted any attempt to influence their views on these issues in the hopes of influencing their decision-making procedures. Even mere accountability, from entities such as the IMF, which has been initiated after relentless pressure was placed on them, particularly after, in the case of the Fund, it made so many grave mistakes as it did during the Asian crisis of 1997-1998.

Problems are not restricted to the resistance opposed by the entities themselves to opening their decision-making processes. There are also difficulties on the other side of the fence. Countries should be better represented in the entities; CSOs should be able to have their voices heard. Eliminating the *democratic deficit* means opening the international institutions to both, but in different ways. Moreover, there is the problem of non-democratic governments, as there is the problem of illegitimate NGOs. Dealing with these questions is not easy, but it is a difficulty that cannot be evaded.

Finally, nothing will probably happen, beyond tokens of doubtful efficacy, if strong campaigns are not organized by CSOs, on the one hand, to push developing country governments to demand more effective participation in those entities, and, on the other, to mobilize public opinion in developed countries to support these demands. This means that NGOs have to design strong mobilization campaigns to explain why these are matters of such a crucial importance to all citizens, that financial markets are not just a game for the rich, but activities that can engender large risks to everyone's welfare as current conditions make more than evident. A campaign could be devised around two overarching themes: first, the need for greater public control of financial activities, working to reduce the democracy deficit in global financial governance; and second, the need to restrain financial sector dominance, designing policies that prioritize jobs, development and income and wealth distribution.

Networks have to be defined and strong alliances must be pursued to this end. Many CSOs concerned with matters such as financial and macroeconomic stability at both the national and international levels are still working in relative isolation. Others are concerned with particular aspects of the problem, such as tax evasion, IMF and World Bank accountability, developing country debt cancellation, participatory budgeting processes, and, of course, trade on services, including financial services, where many regulatory decisions are made without attracting the attention they deserve. A lot of energy and effort put into these activities could be greatly increased if joint action was taken. But wide as this list may be, it far from exhausts the institutions and groups that should be involved in such a campaign for democratic reforms in international financial governance. Political parties, labor unions, anti-privatization campaigns and human rights movements that are increasingly developing work on economic and social rights besides political and civil rights should be natural allies in such an effort.

An important factor in such an effort is creating the analytical capacity among CSO militants and developing country government officials so that campaigns can be led more forcefully and the criticism of neoliberal financial globalization more stinging. To contribute to such an effort has been a central goal of this project.

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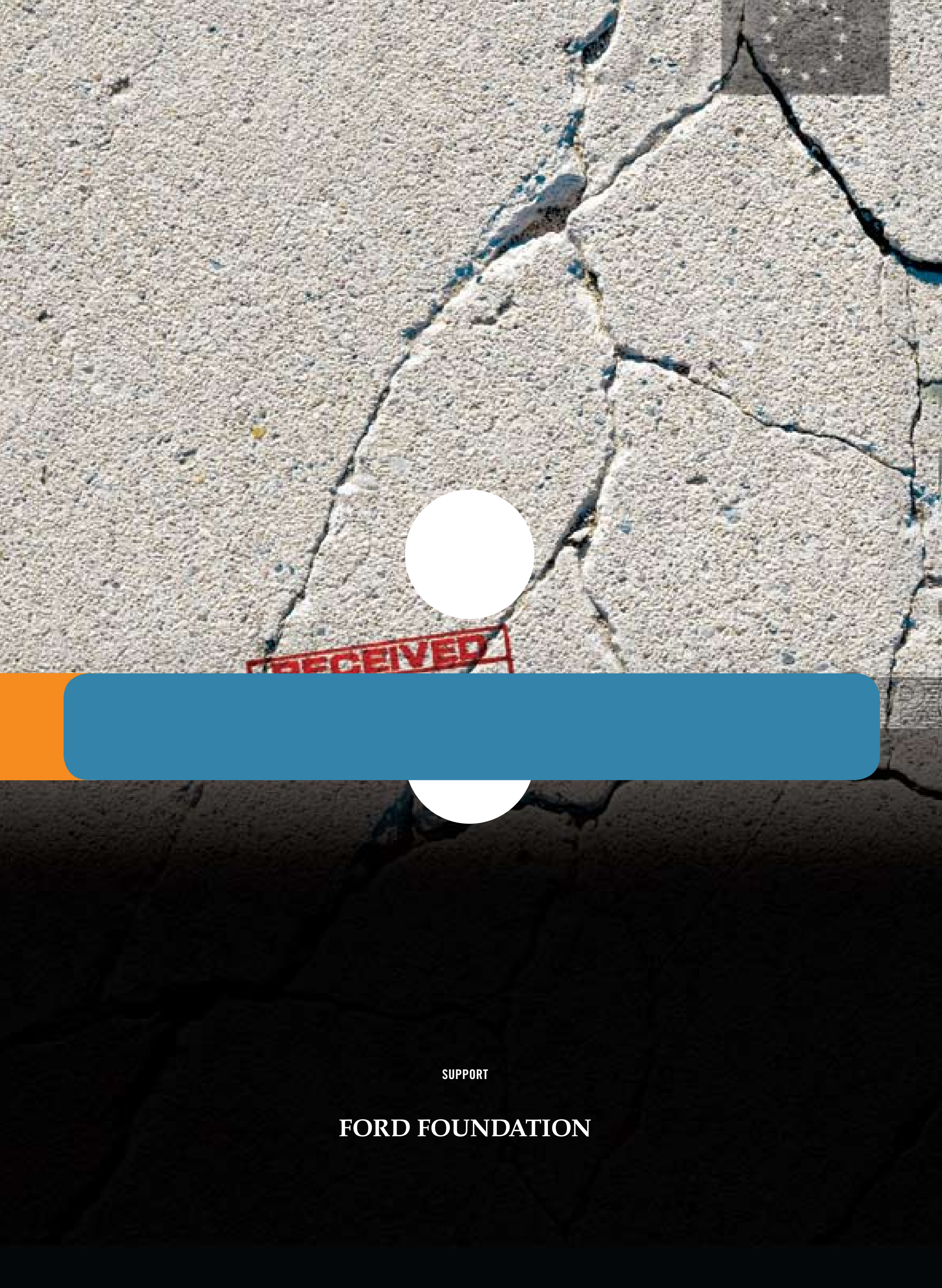

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