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Introduction: the regulatory dilemma in international financial relations

THILO MARAUHN

I. The globalisation of capital markets: benefits and risks

The globalisation of capital markets has become the subject of a broad public debate.[1] It is no longer perceived as a purely technical topic. Its benefits and risks are part of a truly political discourse that has long left the secluded environment of the financial and academic elite. Benefits and risks of such globalisation are thus not only discussed from the perspective of economic rationality but are assessed against a whole set of heterogeneous values, such as democracy,[2] human rights,[3] and many more. While the debate has thus become much more vivid it is increasingly at risk to be governed by ideological motivations rather than rational arguments. Pleading for rationality does not mean to return to purely technical or even elitist considerations. Rather it aims at establishing a procedural framework to accommodate all the relevant aspects that should be taken into account by political, economic, and other decision-makers. Such procedural framework can effectively be provided by public international law arrangements. While this has been realised in other sectors of an increasingly global

[1] See, *inter alia*, Richard A. Grasso, 'Globalization of Capital Markets', (1997) 21(2) *Fordham International Law Journal* 390–6; Dragana M. Đurić, 'Globalization of Financial Markets', (1999) 50(1082/83) *Review of International Affairs* 15–21; Sol Picciotto and Jason Haines, 'Regulating Global Financial Markets', (1999) 26(3) *Journal of Law and Society* 351–68; Eilís Ferran and C. A. E. Goodhart (eds.), *Regulating Financial Services and Markets in the Twenty First Century* (Oxford, 2001); Joseph E. Stiglitz, 'Principles of Financial Regulation – A Dynamic Portfolio Approach', (2001) 16(1) *World Bank Research Observer* 1–18.

[2] Chantal Thomas, 'Does the "Good Governance Policy" of the International Financial Institutions Privilege Markets at the Expense of Democracy?' (1999) 14(2) *Connecticut Journal of International Law* 551–62.

[3] Cf. Ross P. Buckley, 'The Essential Flaw in the Globalisation of Capital Markets – Its Impact on Human Rights in Developing Countries', (2001) 32(1) *California Western International Law Journal* 119–31.

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economy,[4] capital markets have for one and another reason largely escaped the regulatory power of public international law. Even the academic discourse has long been led by economists and experts in private law with a significant silence on the side of political scientists as well as experts in public law.[5] The situation seems about to change, most probably due to the topic moving into the wider political arena.

It is against this background that the research for this publication was undertaken. The basic question to be addressed from a variety of angles is whether there is a meaningful potential in the regulation of international financial relations at the level of public international law. In spite of grand rhetoric such as 'international financial architecture'[6] the present contribution of public international law to a regulatory framework for global capital markets is rather limited. Neither does the reference to an 'international financial architecture' describe an existing regime nor does it provide a blueprint for governance in international financial relations. Rather it covers a great variety of institutions and numerous forms of co-operation among actors on the international financial markets. Whether or not there is a need for and a potential impact of public international law in international financial relations can only be assessed against the background of a much broader analysis.

A first part of this analysis must be a historical one,[7] considering the factual dimension of the problem and the ups and downs of capital

[4] Bilateral as well as multilateral agreements related to foreign direct investment rather provide a framework for the settlement of disputes than a set of substantive standards; cf. Christian Tietje, 'Die Beilegung internationaler Investitionsstreitigkeiten', in Thilo Marauhn (ed.), *Streitbeilegung in den internationalen Wirtschaftsbeziehungen. Völkerrechtliche Einhegung ökonomischer Globalisierungsprozesse* (Tübingen, 2005), pp. 47–62 at 49–51. Similarly, the World Trade Organisation (WTO) does not integrate national economies into the global economy but only tears down barriers to economic transactions in between these economies; see Hans van Houtte, *The Law of International Trade* (2nd ed. 2002), at p. 128: 'A free market requires . . . liberalisation of the movement of goods and services as well as the prohibition of restrictions on competition by the market participants.'

[5] Rochael M. Soper, 'Promoting Confidence and Stability in Financial Markets – Capitalizing on the Downfall of Barings', (1997) 7(2) *Duke Journal of Comparative and International Law* 651–70; Herbert Kronke, 'Capital Markets and Conflict of Laws', (2001) 286 *Recueil des Cours/Académie de Droit International de La Haye* 245–385; Douglas W. Arner, 'Globalisation of Financial Markets – An International Passport for Securities Offerings?' (2001) 35(4) *International Lawyer* 1543–88.

[6] Cf. Peter Behrens, 'The International Architecture of Global Financial Markets' (1999) 6(3) *Maastricht Journal of European and Comparative Law* 271–98.

[7] Such analysis is provided in this book by Benjamin J. Cohen (chapter 1). See also William F. Shepherd, *International Financial Integration – History, Theory and Applications in OECD Countries* (Aldershot, 1994).

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internationalisation. In this regard it must be noted that, in contrast to what is sometimes argued, the internationalisation of capital is not a totally new phenomenon.[8] At the beginning of the twentieth century national capital markets were much more interpenetrated than during the inter-War and the Cold War periods; they were not as segmented and compartmentalised as until some twenty years ago. Nevertheless, developments over the last two decades demonstrate some unique characteristics.[9] Thus, the cross-border flow of financial assets has exponentially grown, and there is a dramatic increase in the number of foreign listed companies at the major stock exchanges. Also, cross-border mergers, increasingly international portfolio investment strategies, a rapidly growing share of foreign investors in the bond market, and even alliances between stock exchanges have by now become commonplace. The fact that a period of internationalisation a century ago was followed by fragmentation of financial markets can be considered a warning that – at least in theory – regulatory change can reverse the interpenetration of national financial markets.[10]

Another part of a kind of preliminary inquiry must be into existing regulations at the national level. A comparative analysis[11] of the national regulation of international financial markets can provide insights into perceptions, motivations and reactions of a broad variety of actors towards a regulatory framework. Findings may extend from a more or less positive assessment of national regulation with a beneficial impact on regional and global markets to the identification of a particular need for co-ordinated, if not partially harmonised approaches towards regulatory issues at the international level. If such a need is identified then the question arises what should actually be covered by an international

[8] Cf. Harald Baum, 'Globalizing Capital Markets and Possible Regulatory Responses', in Jürgen Basedow and Toshiyuki Kono (eds.), *Legal Aspects of Globalization – Conflict of Laws, Internet, Capital Markets and Insolvency in a Global Economy* (The Hague, 2000), pp. 77–132 at 81.

[9] Such characteristics have been aptly analysed by Richard Dale, 'Regulating the New Financial Markets', in Malcolm Edey (ed.) *The Future of the Financial System* (proceedings of a conference held at the H.C. Coombs Centre for Financial Studies, Kirribilli on 8/9 July 1996) (Sydney, 1996), pp. 215–45 at 220–2, available at http://www.rba.gov.au/PublicationsAndResearch/Conferences/1996/Dale.pdf.

[10] Baum, 'Globalizing Capital Markets', above note 8, at p. 81.

[11] Cf. the various contributions in this volume by Eilís Ferran (chapter 2), Rainer Grote (chapter 3) and John K. M. Ohnesorge (chapter 4). For a comprehensive comparative approach see, *inter alia*, Jean-Baptiste Zufferey, *Regulation of Trading Systems on Financial Markets* (London, 1997).

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instrument. This depends on the existing normative[12] and institutional[13] framework but must take into account a policy perspective.[14] This, in particular, necessitates an economic and a political analysis of international markets and interventions into such markets. A policy perspective must also address the interfaces between economic, political and legal considerations which are part and parcel of today's debate on the globalisation of financial markets.

Addressing the benefits and risks of global capital markets by way of introduction can only set the scene. To this end, a more or less 'neutral' perspective on historical developments at the outset of a discussion of whether or not – and if so, how – to regulate international financial markets cannot be sufficient. Before developing a regulatory strategy – and there may be at least agreement on 'prudential regulation'[15] (whatever this means) – some benefits and risks of capital internationalisation must be highlighted. While a detailed assessment would go beyond the scope of this introduction, only a brief overview will be given. As a whole the analysis – and this is also the thrust of the present volume as such – takes a fairly general view without putting too much weight on details of specific regulatory issues. This may be the subject of a follow-up project.[16]

As far as benefits are concerned, integrated markets are economically advantageous in allowing world savings to be allocated effectively, thus favouring their most productive uses across the globe.[17] Also, a political advantage can be seen in improved possibilities for the management of systemic risks, inherent in financial markets, be they local, regional or global. In a more or less perfect economic and political environment this offers countries in recession options for the external financing of investment and thus for the promotion of economic growth while, on the

[12] See the contributions by Volker Röben (chapter 5), Till Hafner (chapter 6), Qingjiang Kong (chapter 7) and Michael J. Hahn (chapter 8), in this volume.

[13] Cf. Thilo Marauhn and Michael Weiss (chapter 9), Susan Emmenegger (chapter 10) and Axel Peuker (chapter 11), in this volume.

[14] See Peter Nunnenkamp (chapter 12), Stefan Voigt (chapter 13) Kunibert Raffer (chapter 14), in this volume.

[15] While the concept of prudential regulation is very popular its precise substance and contents are far from clear. Nevertheless, it can be applied in a meaningful way, cf. Sydney J. Key, 'Trade Liberalization and Prudential Regulation – The International Framework for Financial Services', (1999) 75(1) *International Affairs* 61–75.

[16] For some first thoughts consider Rainer Grote and Thilo Marauhn (Conclusions and agenda for further research), in this volume.

[17] Baum, 'Globalizing Capital Markets', above note 8, at p. 79.

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other hand, national policy failures will be punished by low rates of foreign investment.[18] It must be borne in mind that policy failures can be both, excessive regulation imposing non-competitive costs on transactions, or underregulation burdening potential investors with non-manageable risks. Global financial markets thus offer positive incentives. However, such incentives are not without negative counterparts. Some of them are related only tentatively to the internationalisation of capital as such but rather to interrelated developments. This is, among others, true for the innovation in information and communication technologies and the consequential speed of change. But it also applies to other forces of change, such as deregulatory policies which may be perceived as a weakening of democratic control, in particular if paralleled by a tremendous degree of institutionalisation and professionalisation of market participants. Finally, regulatory powers are generally lagging behind when new financial products join the market. The strongest criticism vis-à-vis global capital markets builds upon their inherent risks and the way such risks have been handled until now. The essence of such risks can be easily explained in referring to the operation of the banking system. Success and potential weaknesses build upon the same sources: intermediation and leverage.[19] Intermediation is a process whereby banks collect deposits and lend them on, with deposits being highly liquid and loans less so. The involved maturity transformation leads to an increased amount of money available for income-earning loans. Leverage means this ability of banks to develop an initial cash deposit into loans that are a substantial multiple of that amount. While intermediation and leverage can be the source of economic growth, their downside is the financial risk they create. Such risks have been considered manageable as long as national capital markets and their risks were contained by national borders and the management of such risks remained the responsibility of the national regulator. With the internationalisation of financial markets numerous crises have given rise to the question of whether and how far such risks can be contained or whether these risks are as infectious as to cause world economic crises. Examples that can be given are manifold, with the

[18] *Ibid.*, at 80.

[19] Cf. Gary Gorton and Andrew Winton, *Financial Intermediation*, National Bureau of Economic Research (NBER) Working Paper 8928, 2002; Felicia Marston and Susan Perry, 'Implied Penalties for Financial Leverage: Theory versus Empirical Evidence' (1996) 35 *Quarterly Journal of Business and Economics* 77–97.

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Mexican,[20] the Asian,[21] the Russian,[22] and eventually the Argentine[23] crises being the most recent (and perhaps the most dramatic).

Referring only to the process of globalisation as the cause of such risks would fall short of proper analysis. What has to be borne in mind additionally is that the public–private dichotomy has seriously changed. The decisive step promoting the development towards globalised capital markets was to remove state controls on external financial relations and to privatise the risk involved. Such privatisation of risks[24] – which occurred in the 1970s with the breakdown of the Bretton Woods system[25] – stimulated a development that first proved beneficial for most actors in international financial relations. Only when governments failed to introduce alternative risk management strategies such privatisation of risks brought about negative consequences, finally leading to a socialisation of such risks with bail-out strategies. When assessing the benefits and risks of capital market liberalisation, there must also be reference to the object and purpose of financial markets, as well as to their functioning. In a liberal (national) market economy such markets provide the financial means for investment and development. However, the liberalisation of international financial markets, their privatisation, and the parallel process of deregulation have not necessarily led to an

[20] Cf. Maxwell A. Cameron and Vinod K. Aggarwal, 'Mexican Meltdown – States, Markets and post-NAFTA Financial Turmoil' (1996) 17(5) *Third World Quarterly* 975–87.

[21] Drawing consequences out of the Asian crisis see Desh Gupta, 'Lessons from South Asian Currency, Stock Market and Economic Crises – Opportunities for Business', (1998) 7(Special Edition) *Canterbury Law Review* 88–101. See also Ian F. Fletcher, 'An Analysis of International Support Packages in the Mexican and Asian Financial Crises', (1998) *Journal of Business Law* 380–96, with some critical remarks on the handling of the two crises by international institutions.

[22] Martin Feldstein, *Economic and Financial Crises in Emerging Market Economies: Overview of Prevention and Management*, NBER WP 8837 (2002); Homi J. Kharas, Brian Pinto and Sergei Ulatov, 'An Analysis of Russia's 1998 Meltdown Fundamentals and Market Signals', (2001) (1) *Brookings Papers on Economic Activity*.

[23] Cf. John V. Paddock, 'IMF Policy and the Argentine Crisis', (2002) 34(1) *University of Miami Inter-American Law Review* 155–87.

[24] The privatisation of risks is only part of what has been described as the privatisation of world politics; cf. Tanja Brühl (ed.), *Die Privatisierung der Weltpolitik. Entstaatlichung und Kommerzialisierung im Globalisierungsprozess* (Bonn, 2001); see also Keith E. Maskus and Jerome H. Reichman, 'The Globalization of Private Knowledge Goods and the Privatization of Global Public Goods', (2004) 7(2) *Journal of International Economic Law* 279–320.

[25] Cf. Richard Sylla, 'The Breakdown of Bretton Woods and the Revival of Global Finance', (2002) 1 *Jahrbuch für Wirtschaftsgeschichte* 81–8. See also H. S. Houthakker, 'The Breakdown of Bretton Woods', (1977) *Harvard Institute of Economic Research. Discussion Paper* no. 543.

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optimal allocation of financial resources. Over the past two decades, financial transactions have not necessarily met the needs of the 'real economy'.[26] What can today be described as 'new financial markets'[27] is characterised by a high degree of volatility, and must be considered a challenge to a global economic framework aiming at stability and sustainable development. While in the long run, liberalisation may end up in a new market equilibrium, the medium and short-term effects have created a culture of speculation with new actors who perceive themselves affiliated to a new powerful economic and political elite. At the same time something close to a regulatory vacuum has emerged.

While the picture that can be drawn of global capital markets is thus ambivalent and complex, it must be recognised that – notwithstanding political preferences of the various actors involved – the internationalisation (and globalisation) of financial markets can be considered much more a *factum* than a *desideratum*. While the interpenetration of markets may be less than complete, it is still as intense as to allow for such a statement. The decisive question from a public international law perspective is whether existing regulatory frameworks at the national, regional and international level are sufficient in order to safeguard the benefits of international financial markets and to reduce the risks. Within this context it is important to recognise that the liberalisation of financial markets was not in the first place the outcome of a deliberate and legally framed political decision of governments and international organisations but was driven primarily by economic actors who won the support of their respective national governments to open up national financial markets. The only – partial – exception to this is the process of European integration. However, as will be demonstrated within this volume,[28] the implementation of the rules on the free movement of capital within the European Union (EU) has only occurred rather late. By way of introduction we will now, nevertheless, first proceed to move forward towards the identification of what may be called the regulatory dilemma in international financial relations.

[26] Cf. Piti Disyatat, 'Currency Crises and the Real Economy – The Role of the Banks', (2001) *IMF Working Paper* no. 49.

[27] Stephen Hessler, 'Neue Regulierungsmodi für neue Finanzmärkte – Zur Notwendigkeit einer Tobin-Steuer', (2002) 77(3) *Die Friedens-Warte. Journal of International Peace and Organization* 249–77 at 254–5.

[28] See the contributions of Till Hafner (chapter 6) and Volker Röben (chapter 5), in this volume.

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II. International markets – national regulation

Financial markets are thus indeed *de facto* international, if not global. Such internationalisation has been driven by economic, primarily non-state actors. Nevertheless, it is important to recognise that at least some governmental support was necessary in order to move ahead. Economic internationalisation and globalisation do not take place in a vacuum. They take place in a regulatory environment that is – at least in the beginning – predominantly national.[29] This national environment is simply due to the existence of the nation-state as the primary standard-setting and enforcement agency in what has been characterised as the 'Westphalian system'.[30] Regulatory power is first and foremost exercised at the level of the nation-state, economically, politically and legally endowed with sovereignty. Such sovereignty – at least as a matter of principle – is still in existence. However it has been modified to a large extent. Such modification perhaps first took place in the field of economic activities and then extended through to political – and at least to some extent – to legal matters.

In order to identify and understand the role of national regulation in the process of economic internationalisation (and eventually globalisation) one may step back a little and consider a fictitious example. Let us consider the case where two undertakings in two different jurisdictions have become aware of each other and consider it useful to enter into economic transactions – both in goods and in financial services. If such undertakings were both operating within the same jurisdiction their contractual relations would be subject to the laws of the land. However, when involving two jurisdictions they must agree on specific rules which may at least be different from those of one of the two. Even if the two undertakings agree on particular contractual arrangements,

[29] For an introductory analysis see Stephen J. Choi and Andrew T. Guzman, 'National Laws, International Money – Regulation in a Global Capital Market', (1997) 65(5) *Fordham Law Review* 1855–908; see also Christopher J. Mailander, 'Financial Innovation, Domestic Regulation and the International Marketplace – Lessons on Meeting Globalization's Challenge drawn from the International Bond Market' (1997/98) 31(3) *George Washington Journal of International Law and Economics* 341–92.

[30] Today, the phrase 'Westphalian system' is used to describe the traditional state-centred system. While there is a tendency to question the predominance of the state, the state enjoys continued relevance in public international law. Cf. Christopher Harding, 'The Significance of Westphalia: An Archaeology of the International Legal Order', in Christopher Harding (ed.), *Renegotiating Westphalia. Essays and Commentary on the European and Conceptual Foundations of Modern International Law* (The Hague, 1999), pp. 1–23.

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those arrangements are only enforceable if the two different jurisdictions provide the pertinent rules to this end. This involves two dimensions: a jurisdiction must allow its 'own' undertakings to extend their activities beyond national boundaries and it must allow 'foreign' undertakings into the country. As far as the exchange of goods is concerned governments may reduce their involvement to a more or less permissible approach. However, in the field of financial relations the situation is much more complicated. A first complication is related to national currencies which are not only of practical but very often of symbolic relevance. The law of money,[31] the regulation of a currency, in particular, its exchange,[32] is a much more sensitive issue than the regulation applicable to the exchange of goods because the currency is often linked to the concept of sovereignty. Even if this is overcome, a second complication must be borne in mind: financial markets have with their increasing relevance always been under close scrutiny of governments. Even at the national level (at least since economic growth during the nineteenth century) they have never been an exclusively private matter but have always given rise to public interference – the most prominent obviously being the exercise of supervisory powers in the fields of banking, insurance, and securities. With the existence of such a supervisory system at the national level, states can still preserve a large degree of sovereignty within the process of internationalisation by, first, allowing foreign actors in and, second, supervising home actors also abroad. The notion of extraterritorial jurisdiction thus comes into play.[33] This still keeps regulatory powers at the national level.

An internationally active undertaking with a strong economy and a solid government at home will not perceive too many problems if it can rely on the extraterritorial reach of its home government. This, however, only applies to a very limited number of jurisdictions, in particular countries with an already strong position in foreign trade and – after the end of the gold standard – countries with a strong currency that is in

[31] For an impressive and still relevant study of the law of money see Fritz A. Mann, *The Legal Aspect of Money – With Special Reference to Comparative Private and Public International Law* (Oxford, 1992).

[32] Cf. Joseph Gold, *Exchange Rates in International Law and Organization* (New York, 1988).

[33] For a general account of the impact of national regulation on international economic activities see Reuven S. Avi-Yonah, 'National Regulation of Multinational Enterprises – An Essay on Comity, Extraterritoriality, and Harmonization', (2003) 42(1) *Columbia Journal of Transnational Law* 5–34. Focusing on the transboundary administrative activities cf. Christian Tietje, *Internationalisiertes Verwaltungshandeln* (Berlin, 2001).

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law (but above all in practice) widely spread and has largely acquired the status of a reserve currency.[34] Not only undertakings from other countries but also undertakings originating in such jurisdictions, however, will be confronted with transaction costs when moving beyond national financial markets. Such transaction costs, *inter alia*, are due to the different legal environments and to different supervisory mechanisms. It goes without saying that those costs will be comparatively higher in the case of undertakings originating in economically less strong jurisdictions. It would thus seem fairly natural that an economically active or at least supportive government will support the interests of private actors in reducing such transaction costs – in other words: it will have an interest to reduce the burden of heterogeneous national regulatory environments.

From the perspective of public international law an international agreement dealing with conflict of laws and perhaps even aiming at some approximation or even harmonisation of normative standards comes to mind. However, this has not been the approach that has been adopted in international financial relations. Private actors, regulatory bodies, and governments have chosen a much more pragmatic but at the same time much less transparent, less democratic and – in the long run – perhaps even less sustainable approach: they opted for international co-operation *below* the level of formal juridification. In other words: they have preferred loose co-operation within the framework of international regulatory financial organisations to international treaty-based regimes. This can be proved by numerous examples: the so-called Basle Concordat of 1983,[35] the Basle Core Principles for Effective Banking Supervision of 1997,[36] and the Basle

[34] Most interesting in this regard is the development of the European currency, as illustrated by Patrick F. H. J. Peters, 'The Development of the Euro as a Reserve Currency', (1997) 2(4) *European Foreign Affairs Review* 509–33.

[35] The 1983 Concordat is a revision of the 1975 original. For a text of the Basle Concordat of 1983 consult http://www.bis.org/publ/bcbsc312.pdf; an analysis of its substance is provided by Peter Cooke, 'The Basle "Concordat" on the Supervision of Banks' Foreign Establishments', (1984) 39(1/2) *Aussenwirtschaft (Zurich)* 151–65. See also C. J. Thompson, 'The Basle Concordat: International Collaboration in Banking Supervision', in Robert C. Effros (ed.), *Current Legal Issues Affecting Central Banks* (Washington: IMF, 1992), pp. 331–40.

[36] The Basle Core Principles for Effective Banking Supervision of 1997 present a comprehensive set of twenty-five principles that have been developed by the Basle Committee as a basic reference for effective banking supervision. They are available at http://www.bis.org/publ/bcbs30a.pdf; for a discussion cf. William Rutledge, 'Presentation on Basle Core Principles for Effective Banking Supervision', (1999) 2(2) *Review of Pacific Basin Financial Markets and Policies* 161–70.

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