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The world crisis: global financial governance: principles of reform

Report

It is now increasingly acknowledged that complex global processes, from the financial to the ecological, connect the fate of communities across the world. Yet the problem-solving capacity of the existing system of global institutions is in many areas not effective, accountable, or fast enough to resolve current global dilemmas. What has recently been called the paradox of our times refers to the fact that the collective issues we must grapple with are of growing extensity and intensity, and yet the means for addressing them are weak and incomplete.[1] There are a variety of reasons for the persistence of these problems, but at the most basic level the persistence of this paradox remains an issue of governance. One significant problem in this regard is that a growing number of issues span both the domestic and the international domains. The institutional fragmentation and competition between states can lead to these global issues being addressed in an ad hoc and dissonant manner. A second problem is that even when the global dimension of a problem is acknowledged, there is no clear division of labour among the myriad of international institutions that seek to address them: their functions often overlap, their mandates conflict, and their objectives often become blurred. A third problem is that the existing system of global governance suffers from severe deficits of accountability and inclusion. This problem is especially relevant in regard to how less economically powerful states and, hence, their entire populations, are marginalised or excluded from decision-making.

This paper describes the current global economic crisis as intimately related to a problem of governance, and articulates simple principles by which the reform of governance can be guided. Increased accountability through participatory reform, we argue, helps to underwrite effectiveness.

FINANCIAL TURMOIL AND FINANCIAL GOVERNANCE

The recent financial crisis has underscored profound weaknesses in the structure of global governance. The existing system of global financial governance has proved largely inadequate to predict, moderate, or contain financial instability. The need for effective global financial governance requires a shift to a better balance between the two worlds of financial globalization: private financial activity on the one hand, and public financial governance on the other. The globalization of financial markets has integrated the global economy in unprecedented ways, and yet the rules and institutions that monitor and regulate financial market activity have not kept pace.

1 See David Held, "Reframing Global Governance: Apocalypse Soon or Reform!" New Political Economy Vol. 11, No. 2, June 2006. pp. 157-176.

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There are many factors at play in the current global financial crisis – the buildup of the financial market bubble, the failure of central bankers to track adequately for house asset price inflation, the near universal incapacity to detect systemic risk, and the power of private sector actors to increase the riskiness of their institutions – to name but a few (see Figure 1 below for a representation of the crash in global perspective).[2] These contributing forces are highly complex, and are outside the scope of this paper to discuss. What can be said is that the existing system of global financial governance failed in a momentous way. What is more is that global economic interconnectedness has meant that the costs of governance failures are widely dispersed across extremely vulnerable segments of the world population. While those in the rich developed world are bombarded daily with news of the deepness of the economic slowdown, less prominent in the headlines are the effects of the crisis on the most vulnerable populations of the world. Recently it has been estimated that as many as 80 million more people could be forced to live in extreme poverty as the result of the recent global financial crisis; this figure is double what was previously feared.[3]

Figure 1: Dow Jones World Financial Index
All daily available data at close, 12 February 1999 – 12 February 2009
Note: The baseline of 100 is equal to opening value of indexed values at 1 January 1992

To be sure, the existing system of global financial governance has some successes to its name. Punctuated periods of international financial stability in the past have produced political demand for, and modest deliverance of, coordination between financial authorities. Like well known institutions such as the World Bank and the International Monetary Fund, the Bank for International Settle-

2 It is worth pointing out that this index is of financial institutions only, and large ones at that. It thus underestimates the fall of the current calamity, since the crisis has bled into the real economy.

3 LSE Press Office Release, "UK launches Growth Centre to tackle global effects of credit crunch", 10 December 2008, available at http://www.lse.ac.uk/collections/pressAndInformationOffice/newsAndEvents/archives/2008/IGClaunch.htm

ments has been transformed over the decades to meet a variety of global public policy challenges, as have the other institutions of global financial governance – the Financial Action Task Force, the Basel Committee on Banking Supervision, the International Organization of Securities and Exchange Commissions, the Joint Forum, and the Financial Stability Forum. Together these institutions have in some respects limited financial regulatory competition among states, provided emergency liquidity and coordinated monetary policies upon occasion, combated money laundering, and strengthened multilateral institutional capacity to react when problems arise.

Yet the failures of this system are even more striking. First, the existing system is predominantly composed of institutions which developed in response to specific problems that arose over the last three decades associated with the reemergence of global finance, and have transformed themselves since then to broader purposes. Subsequently, while these institutions can work together on occasion, there is no clearly defined division of labour among them. Compounding this problem is the fact that the governance of financial markets is an issue which spans both the domestic and the international spheres, and fragmentation and competition between states has led to these global issues being addressed in partial and even erratic ways.[4]

Even when systemic problems have been identified, proportionate action has not been taken. For example, in 2007 the BIS recognized several structural problems with the international financial system, but this recognition remained at the level of research and observation, rather than action.[5] More recently, the Rome meeting of the FSF in March 2008 and its subsequent recommendations delivered to the G7 Finance Ministers and Central Bank Governors in April identified a number of key weaknesses underlying the financial system, and recommended provisions for some substantive reforms. The FSF ambitiously drew up provisions to strengthen prudential oversight of capital, liquidity and risk management, enhance transparency and valuation methods, revise the role and uses of credit ratings, and strengthen state capacity to respond to risks. While some of these provisions are currently being taken seriously, at the time they failed to address the systemic nature of the problems involved, and it took the urgency of a deepening crisis to have the implementation of their recommendations command real attention and debate.

Compounding these deficiencies is the fact that most institutions of financial governance have promulgated an exclusionary model for participation when it comes to dealing with problems which are, at the end of the day, quintessentially global. Despite some recent minor reforms to its voting rules, the IMF remains locked into a system that encourages strong US dominance of the institution. This does not only ensure that its policies reflect existing biases within US domestic politics at any given time, but means that the Fund has been unable to secure sufficient sources of funding to widen its capacity and scope. What incentive do states outside the G10 have to contribute more to the Fund under these circumstances? Consider another example: The Basel Committee designs the de facto bankIng regulatory standards for the world, and yet its composition looks increasingly arbitrary.[6]

4 An example of this is the competitive bank deposit guarantees that swept across Europe in autumn 2008.

5 See Bank for International Settlements, BIS 77th Annual Report, 24 June 2007.

6 The Basel Committee is composed of participants from 13 member countries: Belgium, Canada, the Netherlands, Italy, France, Germany, Japan, Luxembourg, Spain, Sweden, Switzerland, the United States and the United Kingdom. On critiques of the legitimacy and composition of the Basel Committee from a range of perspectives, see Howard Davies, "A Review of the Review", Financial Markets, Institutions & Instruments 14:5 (December 2005), pp. 247-252; Stephany Griffith-Jones Avinash Persaud, "The Pro-Cyclical Impact of Basel II on Emerging Markets and Its Political Economy", available at www.financialpolicy.org/financedev/ persaud.pdf; Geoffrey R. D. Underhill and Xiaoke Zhang, "Setting the Rules: Private Power, Political Underpinnings, and Legitimacy in Global Monetary and Financial Governance" International Affairs, 84:3 (2008), pp. 535-554. The Basel Committee has expanded the diversity and breadth of parties it consults with, but ultimately decisions are still made by the same

Many countries without any formal representation in the Basel Committee have a higher concentration of capital in their banking systems than those within the Committee (See Figure 2 below). Brazilian banks have more capital than Sweden; Australia has more than Belgium; South Korea has more capital than Switzerland; and Chinese banks even have more capital than Germany by this metric. The question remains why the current composition of this Committee – largely an artefact of the state of the financial world in 1974, when the Basel Committee was founded – design banking regulations that are the de facto standards for the whole world? Not only do such member states suffer the negative consequences of the decisions and non-decisions of the Basel Committee, but so does virtually every other country in the world.[7] A similar problem plagues the Financial Stability Forum. While its membership includes a number of different kinds of institutions, effectively it has been a G7-based organization.

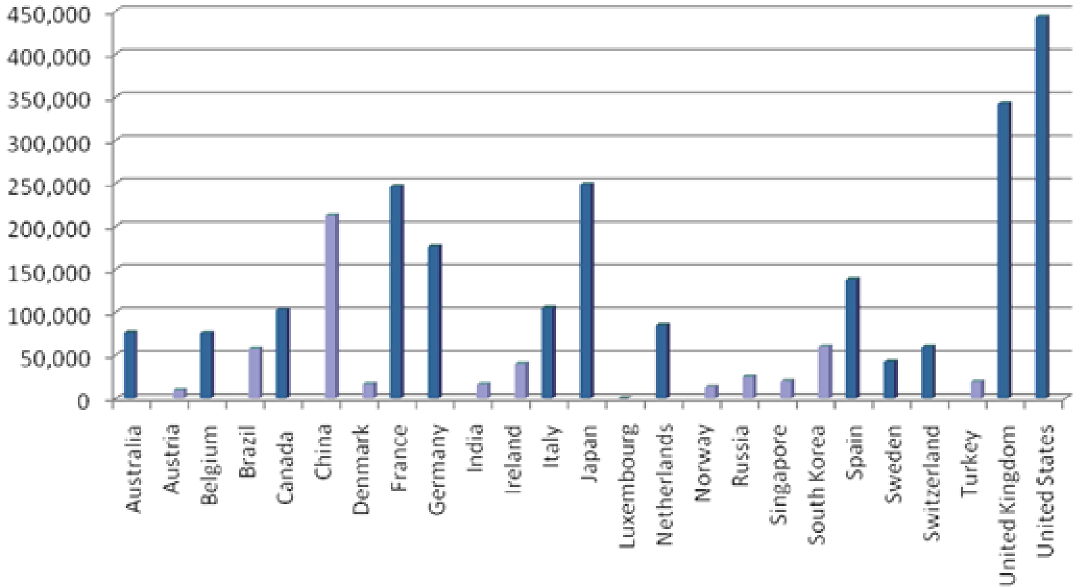

Figure 2: Country Composition of the Largest Banks in the World
Millions of US Dollars, as of beginning of 2008
(Lighter shade indicates non-membership in the Basel Committee)

Source: The Banker, July 2008. The largest banks are ranked in terms of their total tier 1 capital, which has been aggregated by country.

The recent G20 summit in Washington, D.C. saw an unprecedented attempt to engage in participatory reform by admitting countries such as China and India into the Financial Stability Forum. It does represent a significant change. But it is only a small step. Developing countries had to fight and advocate for this, and they will have to do more. No global reform process can be fully effective if it does not arise from a process that is highly inclusive of developing and developed states. As Supachai Panitchpakdi, Secretary General of UNCTAD has pointed out, while few developing countries have been directly exposed to securitised mortgages or failed US financial institutions, the vast majority of them will be significantly affected indirectly through reduced availability of credit, stock market panics, and the slowdown in the real economy.

exclusive group of countries.

7 On the unintended costs of some of the decisions of the Basel Committee, see Stijn Claessens, Geoffrey R.D. Underhill, and Xiaoke Zhang "The Political Economy of Basel II: The Costs for Poor Countries" The World Economy 2008, pp. 313-345.

If reform of the global financial architecture is ambitious enough to be truly effective, it will ultimately be a highly politicized process. The upcoming meeting of the G20 in London has encouraged a useful debate on the matter, and in the time ahead many technical proposals and visions of reformed functions will be proposed. Haunting any process of institutional design, however, is the spectre of governance. To be effective, any new institutional arrangement has to have power – and where there is power there is always the possibility for conflict, which can in turn undermine effectiveness.

With this in mind, proposals in the months ahead should be guided by the notion that participatory reform can help to underwrite effectiveness. Participatory reform within the existing institutions of financial governance could give voice to states and non-state actors that have a greater interest in protection against systemic instability, rather than a stake in risk-taking through profitable financial instruments. In this way, instead of limiting participation according to wealth, participation could be guided by a concept of a global commons – not only a shared set of resources, but a shared community of fate, the very basis of contemporary globalization. As its normative core it could enshrine the principle of equivalence: that is, the principle that the span of a good's benefits and costs should be matched with the span of the jurisdiction in which decisions are taken about that good.[8] At its root, such a principle suggests that those who are significantly affected by a global public good or bad should have some say in its provision or regulation. Such a principle of equivalence could be circumscribed by a concept of the right to protection from grievous harm. In this way, all-inclusiveness would require deliberation and engagement in policies that seriously affect life expectations and chances.[9]

Fuller participation of stakeholders is more than a means to legitimacy. It can also help to underwrite effectiveness. In areas of global governance that seek to protect or promote the provision of a global public good – such as global financial stability and soundness – there are inherent problems when that public good is protected and managed by a minority of stakeholders. This is because in such cases a minority group does not suffer the full consequences of its actions when it is ineffective in its governance.[10] When the costs of financial crisis are distributed so widely, what incentive does an in-group of governing institutions have to reform its practices? Certainly they have some – but the danger is that any response will still be too weak, too uncoordinated, and too modest for the task at hand.

Over the last few months many world leaders have called for substantial reforms the likes of which until recently only a handful of academics and activists were advocating. If any of these reform proposals are to be implemented, one element will be crucial: expanding institutional capacity. The existing institutions of global financial governance each have significant resources and expertise which could be called upon to address the diverse demands of the G20 summit and beyond. Yet any reform agenda geared to balancing the two worlds of financial globalization must simultaneously tackle the divide between the rich countries of the world that have dominated the existing system of global financial governance, and their developing country counterparts that have shared the costs, but have

8 On the equivalence principle, see Inge Kaul, Pedro Conceição, Katell Le Goulven, and Ronald U. Mendoza (Eds.), Providing Global Public Goods (Oxford University Press, 2003), pp. 27-28.

9 On this notion, see David Held, "Global Governance: Apocalypse Soon or Reform!" in David Held and Anthony McGrew (Eds.), Globalization Theory: Approaches and Controversies (Cambridge: Polity, 2007), pp. 252-3

10 These problems of accountability are compounded by the fact that when there is no clear division of labour among governing institutions, the capacity for blame shifting is high, and the feedback mechanism from demonstrable failure to necessary reform does not work.

had little hand in shaping it. Reforms to the system of global financial governance in the years ahead will have to build on institutions already in existence to a significant extent. This is why participatory reform is so vital at the moment. Longer term solutions for effective governance will require centralized coordination and authority, especially once financial markets experience a resurgence, accompanied by a re-strengthening of private financial power.