Introduction: global market integration, financial crises and policy imperatives

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The Asian crisis was the world economy's closest shave since the Latin American debt crisis of the early 1980s and, arguably, since the Great Depression of the 1930s. A combination of currency and financial crises which erupted in east Asia during mid- and late 1997 rapidly developed into a global disturbance, engulfing not only most Asian newly industrialising economies but also Russia, South Africa and some Latin American countries. These systemic disruptions were major, but were not the only examples of financial volatility in recent years. The Asian crisis has been followed by further difficulties in Turkey and Latin America, and at time of writing it remains to be seen what the full effects of 11 September 2001 will be. Indeed, more than seventy financial and monetary crises of different proportions and characteristics have occurred in both developed and developing countries over the past two decades.[1] Large and growing amounts of public money have been committed to tackling the financial crises and their socioeconomic consequences.

A common background to these developments is the intensifying process of global financial liberalisation and integration. Starting with the introduction of floating exchange rates and financial market deregulation from the 1970s onwards, the global monetary and financial system has undergone a radical transformation. Whereas national governments were once effective at shaping socioeconomic policies and development strategies in line with the imperatives of domestic political stability and legitimacy, there is now an increasingly market-oriented and integrated global system. The deepening integration of financial markets has imposed considerable constraints on national policy choices and generated significant strains in various domestic and international policy arenas. As financial crises have become more frequent and more severe over the past two decades, this has raised the question of whether the growing frequency and severity of crises correlate with the emergence of this liberal and transnational financial order.

The root causes of financial crises are most likely to lie in a complex mix of economic, political and social variables across the domestic and international domains. The recent episodes of currency and financial crises in many emerging market economies admit of no single-factor explanations. If the causes of the crises are sufficiently complex as to encourage an open mind, what is equally important is to think carefully, comprehensively and innovatively about the policy agenda. Too much is at stake for developed and developing economies alike to ignore the question of what should be the appropriate national and international responses to the growing intensity of financial crises, as the process of global market integration continues. This concerns both crisis prevention and management. The ongoing crisis in Argentina demonstrates almost daily how monetary and financial problems can spill over into social unrest and problems of governability.

This volume is designed to bring together conceptual discussions, empirical analyses and policy proposals that will collectively address the strategic dimensions, at national, regional and global levels, of managing a highly integrated and liberalised financial system characterised by considerable instability. The major focus is on the tension between the harmonising pressures of financial globalisation led by the advanced financial centres and the prevailing diversity of financial systems, corporate practices and development models throughout the international economic landscape, particularly in emerging market economies. This clear focus and its elaboration through attention to a broad range of related theoretical and policy issues will form a coherent and comprehensive treatment of the dilemmas presented by coping with the brave new world of capital mobility in the global system.

In line with this analytical focus, the volume has three principal objectives. In the first place, and cutting across the scholarly disciplines of political science, political economy and economics, it will advance a set of concepts and arguments which will help us to reflect on the central policy questions involved in the reform and development of the global financial architecture. These concepts and arguments will lend the volume underlying coherence, despite the variety of opinions and analytical approaches among its interdisciplinary contributors. The theoretical discussion will also enable us to understand better and interpret the changing dynamics of the international financial system and its impact on the policy preferences of, and power relations among, the various national and transnational actors and institutions involved in developing the global financial architecture. Similarly, the discussion will illustrate the nature of increasing tension between the rapid integration of financial markets across regulatory and political boundaries on the one hand and national and global macroeconomic policy management on the other.

Second, the volume aims to analyse a range of national experiences with global capital mobility and with currency and financial crises. There are several dimensions to this policy agenda: the effects of global market integration on the pursuit of national economic strategies, the causes and consequences of financial crises, and mechanisms for crisis prevention and management. The volume seeks to show which domestic and systemic forces have shaped responses to the policy problems inherent in the process of financial globalisation and respective attempts to adjust national policy to the new environment. The volume also draws out the policy implications of these national cases in relation to global monetary and financial governance.

Finally, this volume discusses specific policy options open to national and international policy makers in devising patterns of regional and global co-operation to reform the contemporary international financial architecture. Critical issues include how international institutions can be more accountable to domestic political and economic imperatives and how intergovernmental co-operative processes might overcome the tensions among different national value systems and economic development models. Once again, emphasis will be on the policy dilemmas of accelerated financial integration and their implications for the pursuit of domestic socioeconomic policies, the achievement of national development objectives and the management of global monetary and financial relations.

The breadth of this volume sets it apart from similar books in important ways. Recent efforts at the examination of major regional financial crises tend to focus on either macroeconomic and structural factors or on political and institutional dimensions.[2] An interdisciplinary approach sensitive to the interactive effects of economic, political and social factors is not only vital to understanding the frequency and severity of financial crises, but is also, we argue, essential to the effective governance of the global monetary and financial system. The volume has brought together contributors from various disciplines: international political economy, public policy and administration, international economics, business and management, and public and private international law.

The geographical coverage of case material in this volume is also wider than that of many similar books.[3] It presents the varied experiences of both developed and emerging market economies affected by financial crises. It also looks at a broad range of international institutions and private interests involved in the policy debates. Finally, this volume is unique in addressing explicitly the normative dimensions of monetary and financial governance. The argument is that effective financial architecture requires legitimate normative underpinnings if it is to prove acceptable to civil society, in developed and emerging market economies alike, and therefore to function effectively. The current politics of the Argentine street, as the monetary and financial system melt down, should be ample demonstration.

Central conceptual and policy issues

In keeping with the three objectives outlined above, this volume has attempted to address six interrelated conceptual and policy issues which run through its various chapters. The first set concerns the way in which national governments in emerging market economies can and should respond to growing international economic volatility in the process of financial globalisation. While governments may count on multilateral rescue packages in future cases of financial crises, they must defend themselves against financial market instabilities.[4] External rescue packages have increasingly come with often intrusive conditions attached. The modesty of current attempts to restructure the global financial system are, in this light, unlikely on their own to make the financial world a much safer place. The IMF Sovereign Debt Restructuring Mechanism proposals may prove the exception, but emerging market countries which want to avoid devastating financial crises must protect themselves; this requires policy reforms and innovations.

The various contributors to this volume have focused on three policy questions where reforms and innovations are needed, particularly with regard to national experiences following the Asian crisis. They include the proper mechanisms of exchange rate management, the desirability and viability of capital controls, and the design and implementation of sound practices in financial regulation and corporate governance.[5] These policy issues are not merely technical but are developed in a politicised environment. The analyses of national policy responses in this volume, while varied in approach and perspective, sustain the assumption that market reforms are difficult to disentangle from sociopolitical forces, and that officials invariably face political imperatives in the policy-making process. Realistic advice for sound and achievable policy reforms and innovations thus entails a full understanding of their political feasibility as well as their technocratic complexity.

The second set of issues concerns the implications for public policy of the coexistence of distinct national and regional financial system variants with accelerating global integration of these once-distinct markets. While the old distinctions between the national and the offshore have been disappearing, contrasting national or regional financial systems, corporate practices and development patterns seem likely to persist in the foreseeable future. The political, social and institutional features of national economic governance will continue to shape the responses of domestic actors and agencies to the challenges and opportunities created by globalisation.[6] Nonetheless, global financial integration and contemporary attempts at designing financial architecture appear to presume a more uniform environment than is in fact to be found. Even the most well-meaning of policies can suffer compatibility deficits when applied across a range of different national systems.

Following recent financial crises, international institutions, particularly the International Monetary Fund (IMF), prescribed structural reforms in such areas as finance–industry relations, regulatory frameworks, banking practices, bankruptcy procedures and corporate governance. These reforms emphasised the adoption in all countries of a set of codes and standards on financial regulation, policy transparency and corporate management.[7] The persistence of variations in economic and financial systems, however, are likely to pose serious questions to the IMF among others: how can uniform codes and standards of financial and corporate governance be adapted successfully to individual national jurisdictions? And how can we devise effective policies for micro- and macroeconomic management that are compatible not only with contrasting national development norms and goals but also with divergent domestic sociopolitical systems and institutional structures? Concepts such as regulation, transparency and governance do not admit of universal definition, especially at the implementation stage. The structural reforms designed to improve the workings of the international financial system may prove difficult to implement if they clash excessively with different domestic political and economic contexts.[8]

The third set of conceptual and policy issues, which follows on from the second, relates to the fact that national policy makers remain accountable to domestic constituencies and parliaments, despite the global dimensions of economic and social policy problems. Although the individual responses of national governments often make sense in their own peculiar context, which one can hardly ask them to ignore, in aggregate there is considerable room for dissonance and major errors in crisis prevention and management. The very fact that there exist no institutional arrangements for exercising anything like the centralised authority and capacity at the international level complicates the task of managing global financial integration, formulating effective macroeconomic policies, and ensuring adequate supervisory oversight of transnational financial institutions on the basis of national jurisdictions. International organisations are thus faced with the enormous challenges of devising robust strategies for policy co-ordination and global economic governance that are congruous with the priorities of national development needs and the imperatives of domestic political stability and legitimacy.

The difficulties of co-operation in the international system of competing states and jurisdictions are well known. To add to those difficulties, any international co-operative efforts at monetary and financial governance would need to be reconciled with differences in domestic market structures and financial practices, variations in national regulatory frameworks and institutional patterns, and dissimilarities in legal and accounting systems. One issue that has been given special attention in this volume relates to the feasibility of, and possible alternatives to, international co-operation in the domain of global money and finance, under the political and institutional constraints of national sovereignty, prevailing diversity and conflicting interests.[9]

The fourth set of issues examines the role of the private sector in the policy-making process in general and in crisis prevention and management in particular. The private sector is crucial to the governance of the monetary and financial system at national, regional and global levels. Given that private sector activities have increasingly dominated global financial transactions, private financial firms should be integrated into the process of crisis resolution.[10] While the proposition that the private sector is important is widely accepted, what should be the proper balance between private interests and public good? Particularly in financial sector regulatory processes, which are notoriously susceptible to particularistic rent seeking and private capture, this remains unclear. To what extent and under what conditions should governments cede their policy-making power to private market forces? What would be the consequences of private domination of public policy processes for financial stability, democratic accountability and political legitimacy?

The normative dimension of these issues needs explicitly to be recognised by policy makers. As implied above, different national systems are likely to provide contrasting answers. Therefore, a central theme developed throughout this volume is that if the policy mix is simply left to the dictates of global financial market pressures and to dominant private interests, the legitimacy and much-trumpeted benefits of financial openness may prove politically unsustainable over time. This already appears imminent in the Argentine case, and heightens the widely perceived conflicts between the globalisation of finance and democratic forms of governance. The transnational integration of financial markets has affected the changing balance of public authority versus market power in relation to public policy making in the domain of the monetary and financial system. The underlying argument is that the more market-oriented and transnational financial order which has emerged in the past three decades has increasingly aligned economic policy and regulatory processes with the preferences of powerful private interests and crucially altered the nature of public policy objectives in monetary and financial governance. If the financial sector and regulatory policy become unduly dominated by private interests, we risk not only the legitimacy deficit but also economic instability and crisis, as has been so forcefully revealed through the recent episodes of economic turmoil and sociopolitical unrest in Asian and Latin American countries.[11]

The fifth set of conceptual and policy issues is the relationship between the regulatory and prudential supervisory aspects of financial policy on the one hand, and the macroeconomic (particularly exchange rate and monetary) policy aspects on the other. Regulatory policy changes in favour of deregulation imply the liberalisation of capital accounts, with necessary effects on prudential regulation, macroeconomic management and the finance of social and health policies. Nonetheless, regulatory policy changes are typically made in considerable isolation from discussions on macroeconomic policy making and other policy domains. The exception appears to be in small, open economies such as Hong Kong and Singapore, where vulnerability to and dependence upon capital flows, yielding exchange rate volatility, link together financial regulation, macroeconomic management and government finance in the minds of policy makers.

In many developed and emerging market countries, regulatory policy changes are perceived to be necessary in order to enhance the efficiency of financial markets and to please powerful market actors and interests both at home and abroad (the latter usually relating to market access for foreign firms). But the difficulties which the transformation of financial market structures might present for the achievement of major policy commitments of democratically elected governments are given little attention. There has certainly been little consideration of the problems of political legitimacy which market preferences in terms of regulatory and macroeconomic policies may pose for domestic political regimes.[12] In the shadow of the Asian and Latin American financial crises this problem has been felt acutely. Where there are discussions in official circles about the dilemmas created by the formulation of regulatory and macroeconomic policies in isolation from each other, new approaches to the resolution of these dilemmas are still lacking. More systematic discussion of these issues seems desirable as the legitimacy of governments and effective international co-operation often depend on the success of macroeconomic policies.

The final set of policy issues to be addressed in this volume explores the nature of the public interest in the face of global financial integration. The chapters examine a number of more specific questions. What are the goals (by nature contestable) which public policy seeks to achieve in the domain of financial system and monetary management? What role should the financial system and (particularly external) financial constraints play in the process of economic development, especially where social and humanitarian issues are concerned? What should be the proper balance in crisis management between the interests of investors and those of debtor countries and between the interests of creditor countries and those of intergovernmental organisations? This in turn invites discussion of the institutional and legal frameworks for international co-operation and global financial governance. What asymmetries of power and distribution might call a global system operating through international financial institutions into dispute? Answers to those questions point once again to the unavoidable normative content of the public policy choices in financial market governance. The international financial order and the broad impact of its dramatic transformations are not merely technical matters but are essentially linked to such important questions as the global financial system for what ends and for whom.[13] These are the issues which should ultimately shape the ongoing reform and development of the international financial architecture.

The organisation of the volume

The volume has been organised around these six sets of conceptual and policy issues. It is divided into four parts. The first part presents the major intellectual and policy problems under consideration in the volume and illustrates different perspectives on the nature and process of global financial integration. It discusses the diversity of dilemmas and challenges that the globalisation of financial market structures has presented to political authorities at national, regional and global levels, and explores the policy directions which we may consider when thinking about the institutional and normative constructs of the new international financial order against the backdrop of recent financial crises in emerging market economies.

Jonathan Story's chapter leads off with a broad and critical review of the main arguments deployed in the US-centred debate on the fundamental causes of, and proper responses to, the recent financial crises. He places his review in a matrix consisting of the four dominant institutions of the contemporary global transformation – the state system, the state, world markets and multinational corporations – plotted against what he labels the liberal, the realist, the social democratic, and the 'apocalyptic' perspectives typically employed to explain the transformation. Story contends that the current debate on global financial instability has been located within a narrow ideological spectrum dominated by liberals and social democrats, and has ignored or side-tracked the insights derived from the other perspectives, most noticeably realist arguments about power structures. He suggests that an international political economy approach, sensitive to the complex interactions between the state and the market at national and transnational levels and to power clashes conducted through states and among corporations, should be given priority in the research and policy agenda on the reform of the international financial regime.

The remaining three chapters in this section pick up many of these issues, and add new insights into the nature of financial globalisation and crises from different angles. John Williamson's chapter starts by reviewing the arguments, largely developed along neo-classical lines, for capital account liberalisation. It then focuses on the costs of opening capital accounts and integrating with international financial markets, particularly against the empirical evidence derived from recent financial crises in emerging market economies. The claimed benefits and costs of free capital mobility are also evaluated by drawing upon extant cross-national studies on the correlation between capital decontrols and economic growth. The chapter concludes by discussing national policy responses to problems of capital mobility and capital account liberalisation and the role of international institutions in reducing global financial instability.

Benjamin Cohen underscores the theoretical and empirical implications of Williamson's cost-benefit analysis of capital account liberalisation by exploring the political context of the debate about capital controls. Focusing on emerging market economies, he examines how policy debates have been recalibrated as a result of the Asian financial crisis, bringing renewed attention to the old case for capital controls. Despite the shift of opinion among economists and the evidence that capital controls can contribute to domestic financial stability, few governments have opted for this policy option. The principal reason, Cohen argues, has rested with the combined resistance of the US government, international investors and powerful domestic market players. He concludes by offering some suggestions on what might be done to mobilise wide political support for capital controls as a legitimate instrument of state policy.

Geoffrey Underhill and Xiaoke Zhang bring the first section to a close with an examination of the consequences of intensifying financial integration for democratic governance and for the maintenance of a well-functioning international economic system. They argue that increased financial globalisation has severely limited the ability of states to pursue economic and social policies in line with domestic preferences expressed through democratic processes, crucially altered the power balance between public authority and private interests strongly in favour of the latter, and generated pressures for the convergence of financial systems, corporate structures and development models towards market-oriented, neo-liberal practices. They suggest that if the erosion of state policy capacity, the growing dominance of private market interests and the convergence of financial and economic institutions conflict excessively with the imperatives of national security, with the mandates of democratically elected governments and with the requirements of domestic political stability, the process of global financial integration may be called into question or even unravel. These tensions focus our attention on the key issue of political legitimacy and democratic accountability as the real bottom line when it comes to normative underpinnings of the international financial order.

The second part of the volume looks at the interactions between transnational market forces and external political constraints on the one hand, and domestic policy changes before, during and after the recent financial crises on the other, in seven developed and emerging market economies. Country case studies expand on and substantiate the arguments and themes developed in the previous section, depicting national experiences with international financial volatility and examining the role of leading industrial nations and the Bretton Woods institutions in crisis management. Pasuk Phongpaichit and Chris Baker begin by making the case that the IMF-mandated policy reforms in post-crisis Thailand, which were based on the erroneous assessments of local conditions, had negative consequences for crisis management and economic recovery. In their view, the IMF's policy prescriptions had serious flaws because the Fund reflected unduly the interests of the US government and of global investors. The authors suggest that externally imposed policies can go awry when they come into collision with domestic political and economic arrangements, and that domestic policy initiatives and regional co-operation can be an alternative to greater IMF intrusion in national economic management.

Richard Robison presents a case study of the political economy of banking recapitalisation in Indonesia in the wake of the financial crisis. The underlying argument of his analysis is that recapitalisation, involving institutional transformations of central importance to a range of domestic-level state and societal actors, is driven by changes in the architecture of power and interests at the domestic level. Following a brief review of the causes of the banking crisis in Indonesia, Robison examines how the crisis and external pressures shifted the balance of power from the old corporate and political oligarchies towards the alliance between reformist technocrats and populist elements in the major political parties. The shift, he argues, helped to thrust banking recapitalisation and the corresponding reform of the regulatory system on to the policy agenda of the government. The author asserts that the changing configuration of domestic power relations and political interests continue to shape the future course of financial restructuring in Indonesia. Echoing the findings of Phongpaichit and Baker, Robison implies that there may be serious limits to the approach adopted by international organisations to structural reforms in crisis economies, which has given little attention to the constraints of distinctive domestic political structures.

Stephen Harris's account of the South Korean financial crisis is conducted at two interrelated levels of analysis. At the domestic level, the South Korean value systems, corporate practices, regulatory processes and policy-making rules were cast from authoritarian capitalism prior to the crisis, and were not compatible with the important features of South Korea's emergent democratic system. At the international and intergovernmental level, Harris observes that vigorous external demands for financial liberalisation and South Korean state elites' desire for membership of the Organisation for Economic Co-operation and Development (OECD) created strong pressures for policy changes along the neo-liberal lines. The resulting tensions between the lingering legacies of authoritarianism and pressures for market-oriented reforms led to severe governance problems and contributed directly to the outbreak of the financial crisis in South Korea. These observations reiterate the main messages derived from the previous two chapters and heighten the dire consequences of compatibility deficits.