Introduction: the challenges and prospects of global financial integration

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The bitter winds of financial crisis have once again swept global markets, this time beginning at the core of the system, Wall Street. Whether blame be assigned to private greed, public policy lapses, or both, vast sums of public money and shareholder capital have been wiped out in the otherwise noble cause of preventing systemic breakdown. Vulnerable citizens once more count the costs to the real economy. As massive liquidity has been made available to private financial institutions on exceptionally permissive terms, it has been difficult not to notice the striking contrast with the management of earlier crises based in the emerging markets. When they were in the dock, the emphasis was on the conditionality of the terms of rescue; with Wall Street and the City in trouble, the terms of rescue have been much more open-ended.

As growing uncertainty combined with these apparent double standards, the crisis has reopened debate on the global financial architecture, public policy and regulation. Global financial integration and the governance of the global monetary and financial system stand at a crossroads after over thirty years of market-oriented cross-border integration and development preceded and indeed exacerbated a financial crisis on a scale not seen since the 1930s. This ongoing process of integration, regularly punctuated by crises and instability, raises analytical, normative and policy dilemmas which challenge our current understanding of financial and monetary governance. Many scholars argue that higher levels of economic integration require greater degrees of regional and global governance (e.g. Cerny 1995; Zürn 2004). Yet the relationships between economic integration, competitive market dynamics, international political cooperation and potentially new patterns of multilevel governance remain unclear as policy-makers face the difficult task of reform while still coping with the consequences of crisis.

While the capacity of the current global financial architecture to cope with monetary and financial challenges is once again in serious doubt, the future direction of reform remains uncertain. To complicate matters further, not only the capacity and efficiency, but also the *legitimacy*

of contemporary governance arrangements is in question. The current pattern of member-state influence and voting rights in global and even some regional institutions does not (yet, despite the recent IMF quota reforms decided in October 2009) reflect the growing weight of emerging markets in the global economy, despite the costs these economies and their citizens have often paid for the system's volatility. At the same time, global and regional financial governance is characterised by the growing involvement of private actors in both the policy process and in governance, a trend which raises legitimacy questions of its own. In fact it appears that the close and growing involvement of private interests in governance is related to the unequal distribution of costs and benefits in the system, to the risks which accumulated under new forms of financial supervision, and to the way crisis management and bail-outs take place. Both these issues make for an unequal power structure in determining the future direction of global financial governance.

In what is a regrettable but seemingly persistent historical pattern, serious debate on the need for reform correlates closely with episodes of major and costly systemic crises. Perhaps more disturbingly, those crises which imposed relatively limited costs on the core economies of the global financial system generated rather less institutional overhaul than the damage they inflicted on emerging markets might justify. This failure to reform the system more thoroughly and with greater regard to the real nature of the risks inherent in contemporary financial market practice has much to do with the current state of affairs where even the citizens of developed economies are now paying a high price for financial system failure.

An earlier period of policy debate on a 'new international financial architecture' began with the global financial instability of the mid to late 1990s (notably the East Asian crisis). This debate and its limited reform measures came to an end early in the twenty-first century, despite the severe Argentine crisis of 2001–2. Many initiatives were then taken in the field of crisis prevention, with a focus on improving transparency in financial markets and macroeconomic governance (IMF Reports on the Observance of Standards and Codes or ROSCs). New consultative forums emerged as a response to the exclusion of emerging markets (G20) and the need for better overview and supervisory coordination of globally integrated markets (Financial Stability Forum or FSF – recently renamed and strengthened as the Financial Stability Board or FSB). Yet none of these bodies have real power to set rules for global financial governance; much may still lie with the major G7/G10 economies despite the new role for the G20 and the major emerging market countries therein. The one serious institutional innovation in the

field of crisis resolution, the Sovereign Debt Restructuring Mechanism (SDRM), failed to materialise and was replaced by the incremental and voluntary Collective Action Clauses (CACs) and the non-binding private sector 'principles' promulgated by the Institute of International Finance (IIF 2006b). These and other private sector initiatives were as much an attempt to pre-empt public intervention as they were attempts to fill gaps in governance.

The subsequent 'period of calm', 2002–7, saw the consolidation of new forums for international cooperation and the beginnings of a new if questionable Basel capital standards regime. This period bred a sense of complacency that the new global financial architecture was working and was successfully preventing the outbreak of new major crises.[1] Nonetheless, less positive signs were visible to those who wished to see: capital flows to emerging markets and poorer developing countries remained volatile and unpredictable over time (World Bank 2006a). New market developments and players emerged around the explosion of asset securitisation and credit derivatives, private equity and sovereign wealth funds. Private indebtedness combined with asset bubbles in core economies grew, and global payments and exchange rate imbalances (especially around the US dollar) loomed ominously. While this potentially explosive mixture stored up by the market and public policy lapses was brought to the attention of policy-makers by a range of scholars, BIS and IMF reports, and some investors and market observers, the problems were largely ignored.[2]

If the series of emerging market crises underscored the vulnerability of these economies and their systemic importance, developments since August 2007 have shown that core countries in the global financial system are unexpectedly vulnerable to shocks, with yet greater systemic risks. The credit crunch not only demonstrated vulnerability in unexpected places; it showed that the apparently sound and stable financial architecture of the 'period of calm' was less successful than hoped. The most sophisticated of national financial systems were now at the eye of the storm. In these circumstances, the attention of policy-makers has unsurprisingly been absorbed by largely unilateral and ad hoc measures to prevent a further deepening of the crisis, so far with at least an eye on their possible cross-border impact. But it takes a limited degree of perspicacity to observe that the situation could benefit from higher degrees of cross-border cooperation. If the current pattern were to deteriorate

[1] The Argentine and Turkish crises in fact rumbled on for some time, as did the exchange rate aftershocks experienced by Brazil and other emerging market economies.
[2] See Nouriel Roubini's web-based Global EconoMonitor for an overview of warnings.

into competitive unilateralism the danger could escalate significantly. At the time of writing it is too early to tell which way governance will develop. International agreement is still elusive in spite – or maybe because – of the plethora of recommendations tabled by regulators, academics, market participants and politicians.

History may hold important lessons about future scenarios. A significant group of countries have responded to what they perceived as the unsatisfactory nature and extent of post Asian-crisis reform by decoupling themselves from the established institutions of the global financial architecture. They were essentially checking out of Hotel Capital Mobility as built by the global financial architects (Underhill 2007). While they *do* want capital inflows, they are determined never again to submit to the humiliation and intrusion of the conditionalities of the International Financial Institutions (IFIs). In the Asian region this entailed a huge build-up of currency reserves and the development of regional self-help agreements, a build-up that ironically was instrumental to the growth of the US asset bubble (Schwartz 2009). In Latin America, the same feeling translated into the early repayment of IMF loans by Argentina and Brazil and a number of electoral victories by leftwing governments with a clear anti-'Washington consensus' agenda. This seismic shift may yet impair international cooperation. The Fund's programmes have continued to play an important role in chronically indebted Sub-Saharan African countries, while there is little evidence that forty-plus years of IMF policies have been particularly favourable for growth and development (Vreeland 2003). Nor is the rapid growth of international capital flows associated with the post-Bretton Woods global financial architecture closely correlated to economic growth in non-industrial countries, as the (now former) chief economist of the IMF, Raghuram Rajan, among others recently concluded (Prasad *et al.* 2006). While the crisis means that the IMF is clearly 'back' and participating in the rescue of Iceland, Eastern European, Southern and other economies, suspicions of conditionality and policies of self-insurance through excessive international reserves in Asia and Latin America still remain in place.

This implies that eventually the focus must shift back to developing a cross-border framework for global financial governance that is more durable, effective and legitimate. The declining systemic 'weight' of the United States and the dollar and the inclusion of a greater diversity of private actors in a context of integrated financial markets all reinforce the need for new patterns of governance. The crisis and credit crunch remind us that policy issues born of financial integration combined with more traditional monetary questions such as the management of

macro-payments and exchange rate imbalances present enduring and daunting challenges.

The focus of this volume therefore lies on the urgent revival of debate about the requirements of financial and monetary governance under conditions of cross-border market integration. How we understand the relationship between the evolution of markets and of the institutions of governance in the monetary and financial domain will be central to the contributions; a primary objective is to link scholarly analysis more effectively to the potential reform of governance. The volume frames the debate first in terms of both the *effectiveness* and the *legitimacy* of the current architecture and eventual reform. Two contrasting arguments are under scrutiny here. On the one hand, the literature traditionally points to a trade-off between the effectiveness of decision-making (particularly in crisis circumstances) and the incorporation of varying and possibly conflicting interests in a (more) democratic fashion (e.g. Dahl 1994). On the other hand, as argued in this Introduction and in several other chapters, a *lack* of inclusiveness may undermine the effectiveness of governance as few actors will accept the substantive outcomes of an exclusionary process and as the free competition of policy ideas is limited. To work, global rules will need to take heed of local conditions and hence require input from a wide variety of stakeholders. Simultaneously, a lack of inclusiveness may also undercut the legitimacy of governance, as authority serves only the constituencies involved in decision-making.

Although both effectiveness and inclusion may be seen as necessary sources of legitimacy in governance, much empirical scholarship continues to assess inclusion/legitimacy and effectiveness (to say nothing of market efficiency) independently of each other. In a plural system where emerging markets and developed economies vie for influence on increasingly equal terms, it becomes all the more important that reforms address the concerns of a wider range of stakeholders in global finance than has hitherto been the case, and that new and more effective patterns of governance are developed. This volume therefore places the relationships and tensions between decision-making effectiveness, substantive outcomes and legitimacy centre stage.

Scharpf (1999) has famously analysed legitimacy as comprising 'input-oriented legitimacy' (concerning the decision-making process) and 'output-oriented legitimacy' (concerning the substantive outcome of decision-making over time). The volume adopts this distinction between the input/process side and the output/substantive-outcomes side as a second way of framing the debate, but adapts it by observing that though input and output legitimacy can be distinguished for

analytical purposes, in political practice they are ultimately two sides of the same coin: desirable 'policy output' depends on the voices heard on the input side of governance (Mügge 2010, in press; see also Underhill and Zhang in this volume). While the constituencies involved in and affected by financial market governance have potentially conflicting policy objectives and preferences, only a limited range of these constituencies have been included in policy-making at either the domestic or international levels. In this light, a range of chapters in this volume analyse the input or 'policy process' side and the issue of inclusion in decision-making. Others focus on the output side: substantive outcomes, their perceived effectiveness, and their impact on a range of stakeholders and constituencies. The aim is to draw attention to how the problem of inclusion on the input side contributes to a potential lack of legitimacy in outcomes on the output side by affecting the effectiveness and distributional outcomes of governance for the range of constituencies involved.

Within this framework, the volume draws attention to debates focusing on four crucial issues in financial governance. First, there is the question of the proper balance between private participation and interests in the policy process and the broader public good. Specifically, there is a debate among the contributors about whether the decision-making process at the national or international level might be characterised by policy capture on the input side, and how this might skew substantive outcomes on the output side. Second, the question of inclusion on the input side may be specifically raised in relation to developing countries, whose effective participation in decision-making is (effectiveness of recent reforms pending) at best indirect and most of whom arguably have less influence on policy than major private financial institutions in developed countries. On the output side, the system's distribution of costs and benefits is possibly skewed towards the developed economies and their powerful private financial institutions. Third, and mostly relevant to the output side, is the debate on the pressures exerted by the current architecture's norms in favour of financial integration and convergence among national financial systems, which constrain the 'policy space' (Rodrik 2007) available to developing and other economies in the system. Debates around all three of these issues directly concern the tensions between effectiveness and legitimacy, and lead to the fourth issue: because the legitimacy of the current financial architecture was in question even before it was properly established and functioning, it has over time generated *reactions* at national, regional and global levels, particularly in Asian and developing countries. These reactions focus on questions concerning substantive output-side issues

as much as the input or process side. How such reactions should be assessed remains an open question until the current reforms under discussion (or those yet to come) have been effectively implemented: do they strengthen global financial governance? Or are they – consciously or not – potential obstacles to the difficult but necessary endeavour of finding global answers to the challenges of global markets?

The volume addresses these four issues first by analysing the historical context and emergence of the current financial architecture from the mid-1990s to the end of the emerging market crisis period in 2001–2. The next set of chapters looks at how well it works, assessing the input and output aspects of the financial architecture in relation to the first three issues outlined above. A final set of chapters focuses on reactions to perceived lapses in effectiveness and legitimacy and efforts at further reform.

Historical context

Since the emergence of the off-shore Eurocurrency markets in the late 1950s, the combination of cross-border financial market integration and the liberalisation of formerly repressed national financial systems following the collapse of the Bretton Woods system in 1971 has been one of the fundamental transformations of our time (Helleiner 1994) alongside the digital revolution and impending climate change. This turn towards the market in national economic policies marked the beginning of systemic change. The rapid spread of information technology coupled with policies to break down barriers among market segments and national financial systems has altered market structures. The widespread securitisation of transactions and the resulting de-segmentation of financial institutions have created complex and dynamic linkages between banking and public and private securities markets, including the rapidly growing derivatives segment. Capital account opening and the removal of exchange controls essentially erased the distinction between 'national' and 'off-shore' financial markets. The new system is characterised by a high degree of market-led adjustment, product innovation and capital mobility. These developments have vastly altered the financial and monetary rules of the game and have created a more challenging policy environment for governments and international institutions alike. The difficulties for developing and emerging market economies have been particularly marked.

Financial markets presuppose governance – a legal and macroeconomic order in which market and inflationary expectations and adjustment mechanisms among national currencies obey relatively consistent

and predictable rules and norms. Most market agents seek calculable risk as opposed to uncertainty, a climate which is partially delivered by a regulatory and policy environment which allows them to form expectations for the medium and longer term. The assumption behind the emerging market-based system was that market processes would prove self-regulating and, in combination with flexible exchange rates, would generate more stability than the policy mistakes of the 1970s such as inflation, state bail-out and protection of lame duck industries, and growing budget deficits. This 'governance light' came to mean the pursuit of stable and market-friendly macroeconomic policies by governments, providing a positive investment climate as well as market and regulatory transparency at the national level. Private financial institutions and markets were largely left to themselves, under the implicit assumption that they would develop self-regulatory governance mechanisms where necessary. Market discipline would apply to state behaviour and fiscal and monetary policies too. For this last mechanism to work, once-separate national financial systems had to converge sufficiently in terms of regulatory policy and business practice (and therefore market expectations) so as to constitute a more or less contiguous market in the eyes of investors. Yet the degree of convergence in national policies and financial systems required for such a system to function never fully materialised, and is arguably unlikely to do so in the near future.

Some analysts have assumed that market forces would automatically induce policy and financial system convergence over time (Smith and Walter 2003). Others (Eichengreen 1999; Bryant 2003) have argued that the conditions for operating global markets could be consciously developed, but attention to stability and convergence of national policies was necessary. Of course there were also those who argued, on the basis of historical evidence, that financial markets and monetary systems are inherently unstable in the first place (Kindleberger 1982; Galbraith 1995; Strange 1998) so that they required the consistent intervention of political authorities. The persistent pattern of crises, exchange rate volatility and payments imbalances which accompanied the emergence of the market-based system seemed to give the latter the better part of the argument – unless and until the proper conditions for self-adjusting markets could be achieved.

The global 'system' of the early to mid-1990s was in fact a series of complex linkages facilitating high degrees of capital mobility among dissimilar national financial systems characterised by contrasting legal traditions and national policy styles (see e.g. Richardson 1982; Allen and Gale 2000). There were considerable differences in levels of national financial development, openness vs. repression, regulatory

and legal traditions, and national monetary and exchange rate policy imperatives. The combination of these differences yielded high levels of 'dissonance' as capital moved rapidly across borders, responding to a bewildering array of signals under conditions of imperfect information. A host of collective action problems emerged as governments facing adjustment followed policies that made sense for them but not for the system as a whole. National institutional capacities to deal with these problems diverged widely, often worsening the situation in times of crisis. National financial reforms revealed themselves to be less than rational processes replete with unintended consequences. In fact, they were often highly political affairs in which special interests could write their own rules in narrow and effectively closed policy communities (Moran 1991; Underhill 1995; Coleman 1996; Zhang 2003b).

Governments faced domestic private constituencies and political imperatives as well as external pressures which were difficult either to ignore or to square with each other. Investors found themselves in financial environments about which they knew little and cared less (ubiquitous trader: 'we went into Latin America knowing nothing about it, and we came out of Latin America knowing nothing about it'). Investors seeking higher returns sent surges of capital in and out of small and shallow economies, which were often overwhelmed by the effects. The sense of helplessness among their governments was seldom relieved by the intervention of global institutions, the IMF in particular; conditionality imposed difficult adjustment processes, often presenting governments with political legitimacy problems.

Uncertainty appeared to have the edge over calculable risk, while pricing signals became difficult or impossible to read in such a way as to facilitate smooth adjustment. Crises with potentially systemic implications became a regular feature of the system. Following the surprise outbreak of the 1994–5 peso crisis in a Mexico which had undergone considerable adaptation to the new market-based order, the G7/G10 countries initiated reform of what became known as the 'international financial architecture' (Eichengreen 1999). These efforts were redoubled after the 1997–8 Asian crisis with the professed (but contested) aim of strengthening the weakest emerging market links in the system. Regulatory reform and convergence were encouraged through the promulgation of macroeconomic and regulatory standards and codes.

The tensions between global structures and national policy imperatives lay at the heart of the choices to be made (Underhill and Zhang 2003; Zhang 2003b). While the reforms emphasised adaptation of emerging market financial systems to developed country norms – with important consequences for their long-run development plans and prospects – evidence

accumulated that this approach was unlikely to achieve its objectives (Eichengreen and Hausmann 2005). Institutions responsible for crisis prevention and management such as the IMF experienced difficulties designing policies perceived as fair, applicable across national contexts, and distributionally balanced, while erstwhile emerging market economies became serious global financial players, clamouring for influence commensurate with their economic role and weight.

In the midst of this turbulent period, the IMF proposed a major public sector initiative to inject greater levels of predictability and burden sharing in post-crisis debt workouts. In short, the Sovereign Debt Restructuring Mechanism (SDRM, see Krueger 2001, 2002) was a modified form of bankruptcy procedure for countries in crisis. The proposal was defeated by a combination of intense private sector lobbying, related US-based opposition and the opposition of two key emerging market economies, Mexico and Brazil. The SDRM was succeeded by a voluntary private sector initiative developed and led by the powerful representative of the global banking industry, the Institute of International Finance (IIF 2006b). Collective Action Clauses (CACs) for debtors and bondholders, promoted by the G10, became the market standard.

'Governance light' and the market system of adjustment thus appeared to hold sway. The reform process as originally conceived was essentially complete, but the debate about the eventual nature of the global financial system and its governance clearly was not. The volatility associated with the US sub-prime mortgage market shows that the market continues to throw up instability, even in the most developed markets.

The current regime

The volume takes the 2002–7 period of calm as its starting point and focuses on the consolidation of the contemporary financial architecture and ongoing controversies about its legitimacy and effectiveness (Parts I and II) before turning to current crisis-period debates about further policy reform (Part III). In this way the volume (as mentioned) seeks to employ scholarly analysis in relation to potential new departures for the reform process.

The crises of the 1990s made it clear that financial regulation and monetary governance by national governments alone was increasingly ineffective; a market-based system strengthened by sound domestic regulation, better crisis prevention mechanisms, and better national macroeconomic policies and related international monitoring and coordination was billed as the solution. The 'new' international