6

The Need for Institutional Changes in the Global Financial System

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Since the 1980s, persistent episodes of financial crisis in developed and developing countries have put the international financial system under stress. Efforts to reform the architecture of global finance since the 1990s have failed to prevent severe crises from occurring in middle-income countries, and financial integration remains a contentious aspect of globalisation. Despite many attempts at the international level, many developing countries still suffer from high external debt and a poor match between their development financing needs and the availability and forms of both private and public capital. More generally, there is much disappointment and scepticism among policymakers and citizens worldwide concerning the contribution of the international financial system to global development.

Global financial market integration, debt problems and limited and poorly matched resource transfers are realities, and the issues cannot be avoided. Indeed, discussions on reforms to the international financial

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architecture are proceeding, private debt workout mechanisms are being adjusted, (official) debt relief schemes have been put in place, and development assistance is continuously being re-evaluated. Disagreements in policymaking, public and academic circles over the scope, depth, and shape of the reform process remain, however, profound.

The recurrent nature of the debates suggests that deeper reforms to the institutional framework are imperative. The failure of fundamental reform to materialise also suggests that some important blockages in the policy process need to be circumvented if change is successfully to be implemented. Changes for the better will require going beyond the shifting topics of immediate interests among policymakers – i.e. the latest financial crisis, the difficult private-public relationship in debt workouts, or the debt problems of low-income countries – and addressing fundamental questions of the nature of the governance of the international financial system. Furthermore, political strategies to circumvent the current pattern of vested interests in global financial markets and governance will need to be constructed. This chapter's purpose is to lay out the elements that need to be addressed when rethinking the governance mechanisms of the international financial system.

First, we develop a framework for analysing the tensions between the achievement of global and national development objectives and a world of fragmented governance, multiple institutions, accelerated financial integration and increased private sector roles. We approach the topic by covering four sets of interrelated issues, each of which derives from the other: (i) *Forces for change:* How do globalisation, increased financial integration and the emerging norms and standards of global governance affect and define the nature and objectives of the international financial system? In other words, how is the contemporary international financial system different today from when it was put in place, and what issues in terms of governance do these changes raise? (ii) *Public versus private interests and power:* How do these changes in both markets and governance affect the balance of power between public authorities and private interests in international monetary and financial policies? What does this mean for the (shifting) discourses of the "public good/public interest" in financial governance? (iii) *The design of the international financial system:* Are the current rules and institutions of the international financial system the right ones to address the global public policy issues and what sorts of changes in governance can be made to improve the international institutional framework, especially with regard to the global development process? What sorts of obstacles limit the scope for change?

And (iv) *The legitimacy of the international financial system:* How might policy processes and institutions at the global level become more accountable and outcomes more legitimate in relation to the policy preferences of citizens of all economies, in particular of the developing world? In addressing these four issues, we highlight the many concerns beyond the immediate or approximate causes and consequences of financial crises, sustained debt overhang, or poor forms of resource transfers.

1 Forces for Change in the International Financial System

In this section, we examine the economic and financial changes that are affecting the global financial system. Globalisation has involved increased financial integration, increased cross-border entry, mergers and acquisitions of financial institutions, and lower formal and de facto barriers between specialised market segments. These changes were triggered by regulatory changes at the domestic level, particularly in the US and the UK, and capital account liberalisation (Helleiner, 1994). Cross-border capital flows have been the most important form of increased financial integration for the last two decades. Furthermore, capital market integration has lowered the cost of raising capital in developed and developing country markets alike. Spurred by governments that have removed entry barriers, the costs of establishing a physical presence have likewise declined in the last decade, resulting in a dramatic increase of cross-border entry of financial institutions and bank consolidation and financial institutions' mergers and acquisitions across borders and market segments. Finally, in recent years especially, remote delivery of financial services has become much easier; through enhanced communications capability, banking services can now be accessed from anywhere and trading services are no longer restricted to any physical location or exchange.

These structural changes in the markets are a few of the many dimensions of global financial integration over the past two decades. They originated in developed countries as their financial systems and economies matured and they cast off the restrictions of their developmental experience and the heritage of war and depression, and have spread globally. We focus on those dimensions most related to changes in actor preferences in relation to the institutions of governance. One dimension concerns how the changes affect the preferences – financial, political and otherwise – of the public sector, international organisations, private economic actors and citizens. A second dimension concerns the pressures for general economic and policy convergence, that is, those systemic developments that are driving national and local financial systems to search for global or apparently similar solutions. We discuss each in turn.

1.1 Changes in Preferences

Financial integration and globalisation more generally affect the capacities and preferences of different socio-economic actors, interest groups, and constituencies in relation to the nature and objectives of the international financial system. These constituencies and groups include private financial and corporate sector interest groups, state officials, international organisations, non-government organisations, and citizens. The changes are many, and include changes in relation to objectives, tools, and voices.

The end of the cold war removed competition with a rival system and thereby an important anchor to public interventions in national governance and the international system. The demise of a "socialist" alternative and of an active Soviet foreign policy reduced the need to accept social compromises in economic policy as an antidote to unrest and social upheaval in the developing world. As developed economies matured and post-war interventionism lost much of its rationale, models of market-based (or market-friendly) development became central to the policy agenda in western capitals. There was also less tolerance for authoritarian exceptions to more consensual forms of government in emerging markets. The failure of a range of state-interventionist development models to deliver higher income levels in many countries, particularly in Latin America, brought such strategies increasingly under criticism. Despite the successful experience of developmental states in East and South-East Asia,[2] interventionism often appeared to be at the root of problems such as increased inequality, poor environmental performance and other externalities. Chronic inflation and debt burdens induced by state-managed development strategies lent further credence to more market-oriented approaches. At the same time, globalisation introduced more intense competition among countries and firms. All of these trends stimulated changing actor preferences and forms of policy reform.

Correspondingly, the tools of national instances and international agencies changed as policy became aimed at a greater role for local and

[2] Concerning the debate on the "developmental state", see Underhill and Zhang (2005).

foreign private sectors. It gave the international agencies a smaller voice in the world of global opinion and debates. It left national authorities with fewer means to steer local economies, both in normal times and in times of financial crises. Facilitating private sector market processes became commensurately more important to policymakers. While these developments were the intended outcomes, they also had some unintended consequences: new institutions did not necessarily emerge promptly to compensate for the vacuum or the altered sets of preferences. An important element of these changes had to do with the increased role of the private sector in economic activities, which we take up in detail in the next section. We discuss here the consequences for intellectual leadership and international financial markets.

The liberalisation of media in many countries has given all actors more voice. The intellectual leadership of international agencies has become increasingly challenged by more vocal NGOs, whose analysis and research capacity sometimes rivals the agencies themselves. Technological developments such as the internet have allowed smaller groups to voice their opinions more easily. Policymakers have been searching for new solutions as they interacted with other actors in policymaking processes, but they have found this difficult and bewildering at times.

More importantly, the increase in capital flows has reduced the discretionary room for manoeuvre left to public policymakers in the national and international domains. The capacities of official and international agencies to respond to financial crises were in particular limited, both in terms of resources and effective policy implementation. The dual shift towards greater levels of private sector provision of capital and integration across borders has stimulated internationally mobile capital to opt out of historical relationships with public officials and other players in national level policy processes. The greater emphasis on shareholder value and mobility has given capital more voice relative to labour and the liberalisation of financial markets and capital account has given (internationally mobile) capital more voice. The break-up of national policy networks induces further changes in actor preferences.

Another related aspect of change is the larger scope of markets, greater number of players, and the more decentralised nature of transactions. This diminishes the power of individual entities, whether they are corporations, shareholders, government agencies, etc. Moral suasion by central banks, for example, to stave off a financial crisis by "directing" commercial banks is simply much less effective in (international) financial markets today since there are too many players and investors involved. The jurisdiction of public agencies corresponds less and less to the real domain of the market for which they are responsible. These changes have also stimulated a search for influence on the rules of the game, rather than on the market outcomes directly. As such, these trends increase the motivation of actors to search for (global) norms to allow some standardisation, which we take up in the next subsection.

1.2 Institutional Environment Convergence

There has recently been an important degree of convergence in national financial, corporate governance, accounting and many other standards, including non-financial standards (e.g. labour and environmental regulation). The need for standards has increased as the boundaries of the markets increasingly cut across national boundaries. In financial services, increased cross-border presence in financial systems, greater international issuance of securities and other forms of globalisation has led to the spread of similar market practices and "soft" forms of regulations and laws, such as more harmonised issuing standards for equity and debt. There is little evidence that this has led to a decline in banking or capital market standards. If anything, the break-up of national financial policy-making "clubs" and the institution of market-based regulation have led to more and in particular more statutory-based enforcement of standards (Vogel, 1996). As part of the new international financial architecture, there are now many, somewhat higher standards to which firms and countries can adhere to or at least to which they may be held accountable. Examples include the various standards being assessed under the ROSCs (Reports on the Observance of Standards and Codes). More generally, globalisation has done away with some institutional differences and led to more common standards and practices. Cross-border standards imply some degree of harmonisation of the framework under which governments and firms (ought to) behave. Over time and to a certain degree, this convergence will take some of these issues off the global public policy agenda, although less so for developing countries.

Public agencies seek such standards in order to enhance the efficiency of their policies through international cooperation. Yet private interests within developed countries have mostly driven these trends. Private actors seek standards to lower transaction costs through private sector cooperation, and public actors respond to their political pressure. The increased harmonisation of international accounting standards, for example, has been driven by the two largest markets, the US and EU, and has been conducted by semi-private agencies, the International Accounting Standards and the Financial Accounting Standards Board (Dewing and Russell, 2004). Similarly, when firms raise capital abroad or list and trade their stocks on international stock exchanges – as firms seek lower cost of financing and investors value the institutional aspects of international environments more than that of local markets, they overcome some of the institutional differences between countries, but again, this is largely due to market forces. Other standards, such as the Core 25 Principles for Banking Supervision, have had a public sector origin but with much private sector input.

While originating in developed countries, the new global standards have the greatest impact on public and private actors in developing countries. The largest impact from the accounting or the Core 25 Principles for Banking Supervision standards, for example, will be in developing countries. There are several reasons for this. Globalisation in financial services industries has been affecting developing countries the most. Crises have been and are likely to remain largely an emerging market phenomenon. The trend in listing abroad and subsequent effects on what type of corporate governance system firms aim for has been more important for developing countries (sometimes more than half of local market capitalisation is listed or traded abroad; Claessens, Klingebiel and Schmukler, 2002).

At the same time, many of these countries are furthest from the frontier of change and their financial and other systems of governance are less adapted to global integration processes. Many practices under the heading of "financial repression" have been integral to the (successful) development strategies of some of these countries, but sit ill with standards developed in countries that now have a more liberal environment. Consequently, the legal and regulatory institutions of developing countries are often poorly adapted to international cooperation and require extensive changes for the implementation of the new standards. And developing countries have been less involved in the formulation of the standards. Despite the informal input of the G-20 since its formation in 1999, few of the standards developed in recent years have had major inputs from developing countries due to the overwhelming representation of developed countries in the various committees designing the new rules. As a result, the speed and extent of changes are greatest for developing countries.

Despite the increased pressure for standards and the very real achievements in terms of convergence, the process remains incomplete. Global economic space is a long way from the single market of national level economies. The integration process still links often disparate entities at different levels of development or with different sorts of legal and institutional practices. These differences lend volatility to, in particular, the global financial system and they have a differential impact on the various actors and economies involved. Effective convergence and standard setting should put the emphasis more on obstacles to successful implementation and application as opposed to standard setting itself: for example, the focus should be on getting firms to disclose rather than enhancing disclosure rules. Even then, new issues will emerge, global integration will remain imperfect, and standard setting will remain incomplete. Other issues, especially those such as debt workout that are in the main relevant to developing countries, will remain. The deeper issue is whether the political and other constituencies for addressing these questions are in the right place in a globalised world, which is a question on the governance of the international financial system.

In short, both market structures and the preferences of the public and private actors involved have been in considerable flux. As governments sought to promote competition and to loosen the grip of old financial services coalitions on the governance of the sector, cross-border integration was, in part, the result. The most market-competitive financial institutions had long encouraged this process, seeing considerable advantages to a more integrated system and better access to other national markets and other market segments. The structural changes that followed had a dramatic impact on the options for financial institutions, which had to learn to cope with the new environment, as did governments. The impact was not the least for developing countries and their financial sectors. Governments and international institutions alike were confronted with new policy dilemmas that resulted from integration and capital mobility. Crisis and instability led in turn to calls for a reassessment of global financial architecture.

2 Public versus Private Views and Interests

In this section we take increased financial integration as a given and examine the changing balance of power between public authorities and private interests in international monetary and financial policies. This has led, among other things, to shifting discourses of the "public good/public interest" in financial governance, especially as they relate to the development process. Furthermore, it has led to the institutionalisation of private sector interests in the policy process. The private interests of developed country financial institutions are increasingly evident in public policy outcomes concerning financial governance at the national and global level.

The financial services industry has a long history of self-regulation. In the post-depression, post-war world, however, there was a strong determination by governments to ensure that the market dynamics of the financial sector did not operate contrary to the public interest, especially where stability and crisis were concerned. The emphasis was on constraining market forces and integrating the financial sector into national macroeconomic and economic development strategies: private (sometimes state-owned) finance for profit, but subordinate to the wider public good in a democratic or developmental state context (where many European states were clearly "developmental" as well). Liberalisation, cross-border integration, and associated institutional changes over the past three decades have resulted in a greater role for the private sector, less constrained by public policy priorities, at both national and global levels. Within national financial systems, this increased role has come about through the privatisation of state-owned banks, the deregulation of interest control and credit allocations, the removal of barriers between market segments and products and the general liberalisation of product innovation. The dismantling of regulatory barriers has led to consolidation in the financial sector, making for larger, more transnational players confronting government.

These trends have in general resulted in improved financial sector functioning, more stability and greater access of firms and households to financial services (see, for example, Levine, 2005). More generally, the private sector is accepted as crucial for successful financial sector functioning. More contentious, however, is the debate about to what extent, under what conditions, and for which policy goals public authorities should cede prerogatives to private interests in markets when it comes to financial sector regulation and supervision.[3] This is for at least two reasons: the limits to private sector self-regulation; and the dynamics of institutional change.

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[3] There are other arguments, not discussed here, as to what can be best done by the private or public sector related to the general nature and type of public goods.

2.1 Limits to Private Sector Regulation

In all market systems, collective action problems and the possibility of market failure are prevalent. The resolution of these problems requires some form of (private or public) collective provision of regulatory and supervisory authority and policies. Nowhere is this more important than in crisis-prone financial markets. Historically, the public and private sectors have shared the development of regulatory and supervisory functions and institutions. Thus as mentioned above, private sector self-regulation is common in financial services industries. Even where public sector authorities and policies played a dominant role in the post-war period, self-regulation was usually part of the framework, at the very least in terms of implementation.

This is in part because financial services provision is characterised by the use of many and often interlocking networks. The market infrastructure for financial services involves network systems for trading, payment and clearing, distribution (e.g. ATMs), and information. A need for technical expertise and a high level of complexity in the sector plays a role. These networks are often commonly shared and run on a not-for-profit basis by participants themselves, as is often the case for credit registries, or as for-profit organisations, as is the case for many stock exchanges these days. The oversight structures for these commonly-owned network infrastructures often involve self-regulatory arrangements. Sometimes, these are purely private forms of regulation, as in case of many clearinghouses, but often the private forms are mixed with government oversight or delegated mandates. For stock exchanges, for example, typically there will be a division of oversight responsibilities as well as oversight by the public sector of the private sector's own oversight role. Self-regulation is also common in licensing expertise, as for brokerage houses or for obtaining certified financial analyst licenses.

Self-regulation and self-regulatory organisations and associations are likely to work well when the subsidiary body has more specific information, better resources, a broader range of sanctions and more enforcement powers.[4] Nevertheless, self-regulation has its limits (as does public

[4] Self-regulation and self-regulatory organisations may be better able to judge the quality of the application for a brokerage license, may have greater insights in what constitutes market manipulation and have more information systems to detect such behaviour. They may also be able to de-license, issue a reprimand (name and shame), and impose financial sanctions, which may be more difficult for a government agency.

sector regulation and supervision)[5] and needs to be coordinated with other aspects of macro and microeconomic governance. Thus self-regulation is typically embedded in the legal and regulatory fabric of national policy communities and networks across a range of sectors.

There have always been limits to self-regulation, just as there are limits to what public sectors can meaningfully do in a private market setting. The main point is, who makes the rules and for whose benefit? This question is highly relevant in a sector where the (short-term) private gains from regulatory laxity or indeed semi-official cartel arrangements can be considerable, and the longer-terms costs for the whole economy likewise. Particularly following recent scandals in developed countries' capital and financial markets, the limits to private market-based forms of regulation and supervision have become more apparent.[6]

These limits have been in part the result of structural changes in markets, which are in turn linked to liberalisation and cross-border integration. Stock exchanges are losing their monopoly in trading, making it harder to control activities through voluntary and club-type mechanisms. The trend of privatisation and vertical separation of the various parts of the financial market infrastructure, e.g. the demutualisation of stock exchanges, and the separation and privatisation of central counterpart, clearing and settlement functions, have made it more urgent to place certain oversight functions with government agencies.[7] Indeed, the public sector has stepped in to retain more or even to assume some powers previously delegated to the private sector. This happened, for example, with the accounting and audit boards in the US, and earlier with securities markets regulation and supervision in markets like the UK.

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[5] There is much evidence that public sector regulation and supervision of banks serve private interests or the interests of the regulators, rather than public policy objectives (Barth, Caprio and Levine, 2005).

[6] Why these problems have arisen now in what are otherwise very sophisticated financial markets is less clear, but their emergence appears to correlate to the very market-based liberalisation which is discussed in this section. As public authorities have become more reliant on disclosure practices of firms, and the incentive systems for corporate managers depend increasingly on market performance in a situation of intensified competition (in line with the arguments concerning "shareholder capitalism"), personal reward and the social functions of firms in the economy have become increasingly intermingled.

[7] Although it is hard to generalise in this area as many countries, especially emerging markets, coming from more centralised models, are still in the opposite process of giving greater responsibility to the private sector.

The trends are also due to the breakdown in boundaries of once-distinct market segments, particularly the trend known as "securitisation".

Cross-border market integration and the more decentralised nature of markets have their own dynamics, making the picture more problematic. The coherence and shared norms of national financial services policy communities is taxed by global integration, and the jurisdictions of national agencies are tested. Credit and operational risks, for example, have become more complex to assess across both functional market segments and international boundaries. One can expect less from self-regulation in stock markets when the concept of a stock exchange has become unclear with the advent of new electronic trading systems and participants have become increasingly diverse and international.[8] Markets have responded in some dimensions to the increased global nature of financial activities. Clearing and settlement systems that deal with credit risks have emerged (such as the continuous-time linked system for banks), which have also forced coordination in forms of transaction across borders. The increased use of technology has introduced new risks, but private sector groups (such as BITS) assess these risks and propose new approaches. The collective action clauses for bond contracts that countries (both developed and developing countries) under US or UK jurisdictions are increasingly adopting are market mechanisms that have helped as well.

Many international markets and products, however, are too complex to expect purely private forms of coordination to be fully effective. How a handful of commercial banks and the government of major developed countries contained the debt crisis of the 1980s, for example, is no longer feasible. The multiple forms of financing combined with large numbers of creditors and debtor countries make coordination difficult in a crisis, as the events of the fall of 1998 showed, and risk management by individual (national) agencies is insufficient. Financial institutions are also more heterogeneous and are often involved in more activities in multiple market segments. These trends make coordination more difficult and they increase the risk of conflicts of interest (for example, multiple interests, use of privileged information, etc.).

The problems of coordination and the potential for conflicts of

[8] What type of (private or public) arrangements could one expect to cover a trade between, say, a German and Brazilian investor of a French stock listed on a US stock exchange, but traded on electronic trading system owned by a consortium of international investors, but legally incorporated in the UK?

interest have indeed become system-wide. Given the diversity of interests among financial institutions and of national financial systems, it is harder to assemble a coherent coalition of public and private actors for designing new rules. Building institutions of governance at the global level is costly and takes time. In the absence of public forms of governance in which private self-regulation can be designed and then embedded at the global level, one must be modest as to what can be expected from alternative forms of rule-making, such as a Code of Good Conduct, that has been under development for sovereign debt restructuring in recent years.

Despite both private and public inputs, these processes have largely represented creditor countries' views with considerable deference to the interests of private actors, and developing country issuers have so far been rightly so more sceptical of their benefits.[9] The greater coherence among large-scale, private financial conglomerates, which are simultaneously active in the markets and policy processes of a wide range of states, enhances the risk that the rules may be designed so as to (largely) benefit the private sector, in particular the more globally-active and integrated institutions. Apart from the nature of the rules, to what extent will the private sector have the incentive to enforce or to disclose information concerning (non-binding) arrangements? We must at least expect that developing countries will have more urgent and different needs from either the private sector or creditor countries, and global governance must reflect these needs if the development process is to be a success. In the end, only cooperation among national public sectors or properly global institutions can deal with free riders and enforcement.

2.2 Dynamic Effects

The dynamics of institutional change are complex in any policy domain, particularly where the liberalisation of financial markets is concerned. There are obvious links between the institutional environment and the successful functioning of the financial sector, as the law and finance literature and recent financial crises have shown where weak or missing institutions hamper growth or cause crises. The lessons that the institutional environment needs to be consistent with speed

[9] Developed countries' market participants are also concerned about the new codes, but more likely because they may lead to legal liabilities and thus costs should they take the form of statutory or regulatory standards.

and forms of financial liberalisation and deregulation are now more accepted, although there are still many questions about what constitutes an institutional environment appropriate to a particular type of country at a specific level of development.

Liberalisation by definition cedes prerogatives to the private market forms of interaction at the expense of public agencies seeking to direct the course of economic development. While in many cases liberalisation may accomplish public policy goals better than state intervention, it will not always do so. This is particularly the case where endemic forms of market failure, such as financial crisis, are present. An even more complex issue is the dynamic by which economic reforms (financial liberalisation, capital account liberalisation, and privatisation) affect the balance between private and public interests in shaping the institutional environment. History tells us that a variety of models can work, but that some combinations clearly lead to trouble. These endogenous forms of institutional change are still poorly understood.

These dynamics must be understood in terms of the nature of policymaking in the financial sector, wherein the stability and successful functioning of the financial system is closely linked to state and wider public interests. Economic development and growth requires successful financial intermediation, and states themselves are heavily involved in debt and other financial markets: states thus need and overlap with financial institutions. This situation is accentuated in the case of developing countries. Given their (perceived) systemic importance, commercial banks have traditionally benefited from a large safety net provided through various means (deposit insurance, lender of last resort, etc.). Most financial services markets have some form of more or less intrusive public sector regulation and supervision. Regulation and supervision are unlikely to be successful without at least minimal consent of the sector itself, and where this is largely private, the consent of these private interests. This means that private financial interests become privileged negotiating partners in these crucial policy processes. Their preferences are the most likely to be enshrined as public policy, particularly where states are anxious to attract capital for their own or general development needs.

Furthermore, financial services are characterised by low transparency and central banks have traditionally had close and relatively exclusive relationships with banks and other financial institutions that fostered this. Central banks are, after all, banks, and they certainly think more like banks than they think like ministries of economic development.

Given this closeness of public and private actors and their shared interests in the policy process, the definition of public interest as distinct from the interests of private sector itself is consistently difficult in financial services industries, leaving greater scope for private interests to affect rules and outcomes. Thus although many improvements in the institutional environment have been a response to or codification of market forces, regulatory capture is a persistent threat.

The forms in which the private sector may gain too large a stake will vary by economy. In developed countries, they make take the form of lobbying and regulatory capture, which may not breach formal laws but can undermine public policy objectives. The role of the private sector in lobbying for financial sector regulatory change in the US (say the repeal of the Glass-Steagall act separating investment and commercial banking) and some other developed countries has been well documented. Heinemann and Schüler (2002) conduct a cross-country analysis on supervisory systems and financial structure in Europe and find empirical support for the private interest (Stigler) view on regulation aimed at a "preference for laxity," and less so for a "barriers to entry" view. At its worst, lobbying for a regulatory framework of "shareholder capitalism" deteriorates into Enron, WorldCom and securities market scandals involving outright crookery.

In developing countries, the dynamics unleashed may, in addition or instead, take the form of more overt corruption, e.g. banking licenses up "for sale", or a call for more securities markets regulation and supervision being ignored for (too) long as insiders have captured legislators. Alternatively, there may be rampant clientelistic lending in which, for example, industrial concerns are permitted to own financial institutions and thus effectively lend to themselves at will, all of which goes unchecked or is poorly supervised. Importantly, the dynamics can influence the development processes in diverse national economies differently. While in more developed countries, these problems may introduce minor distortions and adverse growth consequences, in emerging markets they can lead to financial crises with large output losses or severe growth costs, and major wealth redistributions (Zhang, 2000).

While corruption and weak governance is not new, these dynamics were not entirely anticipated. The breakdown of financial repression and other institutions of developmental states was bound to be dramatic and to result in a reshuffling of the political as well as the economic cards (Zhang, 2002). Many reform and adjustment programmes still have faltered for reasons of misjudging the dynamics, e.g. few foresaw the adverse dynamics of mass privatisation in terms of creating no or little constituency for improving the institutional environment in transition economies. While one cannot perfectly assess these possibilities *ex ante*, an assumption of diversity among cases and greater attention to the political dynamics of policymaking and legal institutions in various national settings would be a start. Global financial governance must take such problems as starting points, not afterthoughts.

As an analytical exercise, the respective responses and capacities for adaptation of different (public and private) actors relative to the speed, type, and sequence of deregulation, privatisation, etc. in a dynamic institutional environment need to be assessed. Here aspects such as the expected drain of human capital from regulatory and supervisory agencies or the anticipated rents to be earned from bribing officials once a financial system is liberalised need to be brought into the picture. In addition, in liberalising institutional investors, one should anticipate shifts in regulatory preferences, e.g. preferences for different (better or worse) regulation, supervision, and corporate governance.[10] In essence, though difficult to predict, the changes in market structure and institutional and normative framework of governance needs to be plotted against potential changes in actor preferences.

At the international level, evidence is less abundant, but the dynamics are no less troublesome. Private banks have clearly played a major role in pushing for cross-border liberalisation in both developed and developing countries. As liberalisation began, the coherence of private-public sector interactions at the national level was diluted, but the jurisdictions of state agencies remained constrained to the national level. Despite some eventual successes such as the Basel process, cross-border cooperation was, as always, difficult and slow to emerge. Furthermore, it tended to be crisis-led since crises forced national authorities into more supervisory or other cooperation. Private interests (free of cumbersome questions of sovereign or legal jurisdiction) were much quicker to regroup in coherent coalitions at the international level, for example the Institute for International Finance (IIF), and private preferences of globally active institutions tended to converge quickly, as noted above. Once again, the influence of private interests in evolving mechanisms of global governance may have been too strong. It has been

[10] In addition, the effects of changes in regulation on financial institutions' and financial markets participants' profitability and franchise value would be analysed, and how that in turn may affect the ability and incentives to manage risk over time.

argued, for example, that the Basel II capital accord reflects private interests to a much greater degree than did Basel I (Soederberg, 2002; Wood, 2004). Supervisory agencies were involved in close relationships with international banks as their essential consultative partners in the negotiations. Banks were particularly effective in making their case in what ended up being very technical discussions (see further Claessens, Underhill and Zhang, 2003 for this argument).

Dynamics at the international level also have implications for developing countries. Again, as for domestic liberalisation, there can be benefits. A process of international liberalisation and greater financial integration can constrain discretionary macroeconomic policies, which can be (more) valuable for inflation and debt-prone emerging markets. As in a domestic context, these beneficial pressures of the private sector can take many forms depending on the individual case (e.g. better standards for credit cards as international lenders enter). On a system-wide basis, there have been many beneficial forms of global self-regulation, such as the various standards mentioned before. But there can be perverse consequences, maybe even more so than for domestic transactions and institutions.

For one, a global system is far from transparent and considerably dilutes the influence of developing countries on financial markets. They face the power of both public and private agencies of developed countries, often in coalition with each other. Lines of authority are far from clear and developing country preferences are difficult to enforce in the light of urgent development needs. Geopolitical and other factors add extra spin to the problem. There are thus more degrees of freedom for the private sector to operate in ways favourable to their own interests rather than in line with broader international or national development goals. In many markets, especially developing countries, foreign players have a large role in domestic financial markets and can "threaten" national agencies, thus gaining a stronger voice than the public interest calls for. This can be done directly, say in case of emerging markets and developing countries in times of financial distress, as the arguments used for (many) bailouts by governments of foreign investors. Or it can be by having international agencies pursue policy conditionality on international aspects more favourable to private interests.

Although it is less likely than it would be in a domestic context to take the form of corruption, the consequences can be equally severe. The financial bailout of crises, for example, seems to have benefited international lenders disproportionately at the cost of domestic investors and taxpayers, especially the poor. When these outcomes confront the legitimate and democratically expressed policy preferences of developing countries, the dissonance is considerable, and they find themselves with little influence on the norms and outcomes set by global governance processes.

As noted, global arrangements such as the Basel Committee are characterised not only by low transparency but may have furthered private sector interests to the detriment of developing countries, are even less accountable to their national interests, and may have aggravated matters (see Coleman, 1996). The (long-ongoing) debate on sovereign debt restructuring mechanisms is another example. The private sector, in particular financial intermediaries, has argued against debt restructuring mechanisms since according to them, those would lead to higher costs of debt. More likely, however, their opposition is motivated by the fact that, as investors, they will be worse off since such rules will in part reduce the scope for moral hazard and (unnecessary) bailouts. Private interests resent potential constraints on their freedoms even when it can be clearly demonstrated that debt workout arrangements, which work perfectly well at the domestic level, would be better for all, including the banks, in global crisis situations (Miller and Zhang, 2000).

The issue is not so much that private parties will argue for their own interests, but rather that the institutional framework and the position of all actors do not allow for a proper balancing of private and public views and of various countries' views. Global level governance is not anchored in the sorts of chains of (democratic) accountability that serve to amplify the voices of weaker actors at the domestic level. Private bondholders or taxpayers, perhaps more interested in clear rules, may be less organised than commercial banks that benefit from less clarity. Countries may face conflicts of interest or time-consistency problems in terms of pushing for solutions. The outcome may not only be unfair, but also inefficient. In many cases, there have been delays and the lack of public regulation has not been filled by global self-regulation, or vice versa.

3 Design of the International Financial System

In this section, we investigate how to analyse the design of international policymaking structures and institutions given the identifiable problems facing the international financial system and preference-setting in national contexts. Here, the basic question is whether the rules under which the international institutions currently operate are the "right" ones from a first principles point of view. The question can be addressed using several types of approaches, some of which we will discuss.

3.1 A General Public Economics Approach

A general public economics approach can be used to analyse the design of international policymaking structures and institutions, given the identifiable problems facing the international financial system and preferences developed in national contexts. A useful starting point is the definition of global public goods related to the international financial system, fulfilling the criteria of non-excludability and indivisibility (consumption by one or many does not reduce availability for others).[11] These public goods could include: international financial stability and efficiency; adequate reliability of contracts and property rights backed up with the presence of efficient, *ex post* enforcement mechanisms; a lack of abuse of the international financial system for purposes deemed economically undesirable (e.g. financing of polluting activities or those adding to global warming) and other global merit public goods. Complementary, the potential tools for ensuring the provision of such public goods would need to be identified (e.g. taxes, quantity restrictions, policy harmonisation, disclosure, specific rules or institutions), a far from obvious exercise, but not the focus of our analysis here. (Of course, many of these global public goods do not relate to the international financial system alone, and as such may require other analyses, tools and interventions as well.)

Once the global public goods and potential and necessary policy interventions to achieve such goods have been identified, questions to be addressed include: what global public policy issues should and can be productively delegated to international levels (or sophisticated forms of transnational coordination)? Correspondingly, what forms of representation should exist at the international level, given a set of national

[11] One can further distinguish "merit" goods and other, "welfare" goods. As an example of the latter, citizens of developed countries may well care about the welfare of citizens of developing countries, not just because of their own interests, and therefore a certain design of the international financial system may be perceived as more desirable. Here we focus largely on the question whether the design of the international financial system is best in terms of delivering merit goods.

preferences and a need for national forms of representation? More specifically, many problems in international financial markets have to do with coordination issues, as in times of financial distress or financial crises. What arrangements might lead to the best resolution of the collective action problems inherent in many aspects of international financial governance? As a very specific question, what governance structure is preferable for an international lender of last resort or functional (cooperatively-based) equivalent?[12] Or more broadly, what constitutes a consistent set of national and international forms of representation that effectively provides for necessary public goods at the global level, yet at the same time respects the process of preference formation at a national or regional level?

Obviously, the design and functioning of international organisations is a broad area, on which much research has been undertaken (by political economists, political scientists, and international legal scholars). Questions on the issue of enforcement especially need to be addressed. Countries are notionally sovereign, despite power differentials and the constraints of interdependence, and can always *ex post* deviate, as has been observed for both developed and developing countries (e.g. the *ex post* deviations from the EMU Growth and Stability Pact and the many defaults on international contracts). At the international level, the basis for successful governance is clearly an underlying consensus on the tools and objectives of cooperatively-designed policies. Nonetheless, to be effective, agreements and institutions also need to be self-enforcing (including dispute-settlement mechanisms) or to derive their commitment from either clear positive incentive structures for all parties or from political enforcement mechanisms. Given power differentials, this has many implications, among others for representation, and the form and impact of competition among international agencies. Even the powerful must be subject to the rules.

In a domestic context, a majority system may deliver the first best outcome on how to assure the provision of national public goods (although even this is not clear in the context of say information asymmetries or prevalence of interest groups). Even so, provision for minority opinion and rights is an important part of domestic democratic governance. In an analysis of the preferred voting system for international agencies, however, it has been found that under self-enforcement,

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[12] The lender of last resort is different from that played by the IMF so far (see Fischer, 2003).

unanimity is most often the optimal system (Maggi and Morelli, 2003). This unanimity principle is not dissimilar to how cooperatives, including financial cooperatives such as rotating savings associations, work in low or weak contracting environments. Whether this result applies to international finance and international financial organisations more generally is, as yet, unclear. Certainly, the general difficulties of unanimity systems in yielding effective decisionmaking and in coping with power differentials are not unknown. The need for speed and efficiency in decisionmaking, important in financial markets, militates against the unanimity principle. Formally, we observe mixtures of unanimity and majority-voting systems in international financial organisations, although in practice unanimity decisionmaking is most commonly, even in majority systems. Thus, decisionmaking in international cooperative environments regularly hinges on broader perceived national interests, not just interests related to the narrower mandate of the specific organisation, e.g. financial stability. Yet, this can clearly sometimes lead to unfair outcomes. In the context of the HIPC debt reduction initiative, for example, relatively poor developing countries like Costa Rica that were creditors to HIPCs were obliged to accept official debt reduction even though they had no say in the design of the HIPC initiative.

Another issue is that the lack of enforcement mechanisms can lead to unwarranted competition among international organisations. Agencies must continuously demonstrate their value to members: that the costs of deviating from the particular arrangement are higher than the benefits of staying in. This creates competition, which may explain the continued flux of private, public and mixed agencies involved in international financial affairs (for example, the G-20 and the Financial Stability Forum are newly established). Since investments are costly and highly specific, especially in financial markets, there are nevertheless limits to competition and switching, thus sustaining international institutions to some degree. Furthermore, legal conventions provide some international agencies with authority in specific areas (e.g. the IMF and World Bank through the Bretton Woods conventions).

The recent changes in international financial markets nevertheless affect the ability of some agencies to sustain themselves, with some declining in importance (for example, the Group of Thirty was more important some years ago) and others increasing. International agencies also adapt, of course, as the BIS/Basel process has done (moving from the interwar role of a bank for settling national debts to a forum for

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international monetary policy coordination among central bankers and somewhat of a global financial regulatory body (see Felsenfeld and Bilali, 2004). And the Institute of International Finance has altered its focus from being a depository for and clearing-house on country risk data and analysis concerning the 1980s debt crisis to an advocacy group for international commercial banks. There is some considerable path dependency, of course, and as such it is hard to generalise about how the international financial system will evolve, but one can be sceptical whether, with such dynamics, it will lead to the most efficient outcome. Since little research has been done in this area, however, answers remain elusive for now.

3.2 Agency Approaches

Another approach would be based more on principal-agent, agency perspectives and game-theoretical approaches. Taking thus a more political economy but still rational choice approach, one can try to adopt an agency perspective to the international financial system. Principals in various groups try to pursue their own interests with agents in various forums voting on their behalf. Here one can think of lobbying models where lobbying has rewards for interest groups because it affects decisionmaking. The "technology" for affecting decisions can be through direct payoffs, through bargaining, or by using informational advantages. Lobbying may have first mover advantages (full competition in lobbying may otherwise lead to degenerate results), treats points may arise from other areas (e.g. international politics), and informational advantages may arise from superior knowledge or resources. This approach has already been applied in case of domestic financial reforms (see for example Pagano and Volpin, 2005; Perotti and von Thadden, 2004). In less democratic countries, lobbying on legislation and enforcement can have a major impact on financial development and thus entry. In highly unequal countries, poorer elected politicians and poorly paid public officials may be more vulnerable to offers of bribery. Then lobbying allows smaller groups to exert a disproportionate political influence on legislation or its enforcement, as first noted by Olson (1965). Olson also observed that collective purposes and action are more easily undertaken by small, single purpose organisations than by broad, multi-purpose coalitions. In short, this literature models legal and financial institutions as the outcome of political choices.

The international context is even more complex. One approach is to model it as a two-step agency problem, with private principals ("citizens") interacting with governments as agents at the national level, and then, at the international level, governments as principals interacting with international institutional "agents" like the FSF or the IMF, as well as private agents, like IFIs. The risk is that specific private interests, rather than the general public interest, become the main principals and governments/public agencies their agents. Furthermore, power differentials mean that only the more powerful countries can realistically expect international institutions to behave as agents.

One can also analyse the international decisionmaking processes using a game theory approach, again possibly in two steps. Private groups bargain with public agencies and in turn, governments bargain with international agencies, and sometimes international agencies bargain directly with private interests, each having certain strengths and threat points. While these and other types of models have been used and empirics have been conducted on the political economy of domestic financial reform, so far, few of these approaches have been applied internationally. Likely, it will remain difficult to make any statements on what these approaches will teach us about the design of the international financial system since there are so many parameters to consider. Furthermore, antagonistic bargaining models do little to account for the close links between (national or international) public institutions and private sector organisations, including the potential prevalence of capture. Just because we consistently distinguish analytically between public and private sectors does not mean that their interests in governance necessarily diverge.

Related to these approaches would be efforts to identify the principal-agent combinations or coalitions interested in international financial reform. In a domestic context, one can expect, for example, shareholders to be interested in voting on corporate governance reform, or depositors to be possibly interested in better banking system regulation and supervision. Although relationships are very indirect, cross-country analysis has indeed found relationships between financial and ownership structures and the interest in such reform on the one hand, and actual reform on the other (see Pagano and Volpin, 2001 for a review). Some empirical analyses exist of international financial decisionmaking, such as the role of political factors in IMF and World Bank adjustment lending programmes or the allocation of official development assistance (Alesina and Dollar, 2000). But further empirical analysis at the international level is needed.

These rational choice perspectives can provide valuable insights into the likely ways in which different sorts of interests in a given setting are likely to interact. However, the models will at best remain suggestive of correlations between actor preferences, e.g. principal-agent relationships, and actual decisionmaking outcomes. Models have difficulty demonstrating definitively who or what, with which preferences, led to which outcomes in the sense of causation, particularly where public and private interests interact closely and consistently in a specified institutional environment, yielding a process of socialisation to accepted norms, ideas, and practices which may exclude even demonstrably necessary policy alternatives. In the end, there is likely to be no substitute for detailed empirical research into the preferences and relative resources of actors, the institutional settings in which they interact, and the resulting coalitional politics cutting across national and institutional boundaries that lead to outcomes.

3.3 Lessons from Current and Historic Arrangements

Analysis, theoretical and empirical, is likely to show that many of the current institutional arrangements lack essential economic and political justification. This is surely true of long-existing institutions like the IMF and World Bank where the current percentage representation of shareholders no longer reflects the relative economic or financial importance of countries. Voting processes do not necessarily satisfy any optimal voting model in terms of either representation or decisionmaking efficiency. There is already a debate underway that can help clarify the preferred structures as well as shed light on the underlying political economy factors.

Similarly, sub-optimal and unrepresentative processes have developed recent reforms to the international financial architecture, with commensurate defects. Which precise policy gap was the Financial Stability Forum intended to fill and why did it emerge with its specific composition of countries (G-7 plus some international organisations)? The various G-groups (G-7, G-8, G-20, etc.) are outside the formal institutional framework, yet they are very important in building coalitions driving specific policy and institutional changes. How might they be conceptualised? What was the anticipated role of the G-20 and why does it include these specific countries? How do these organisations and groups function in practice and how does this relate to their stated objectives, if any? Was the G-20 only an attempt to co-opt the non-G-7 countries into the rules and standards of the G-7, has it been dominated by the United States, or has it led to genuine broader representation? Much can be learned from analysing the political economy of the origins and the effectiveness of these recent and older international institutional arrangements.[13]

Lessons can also be learned from the EU/EMU and other regional (financial) integration efforts (NAFTA, EFTA, AFTA, Asian Monetary Fund). The evolution of the EU has been a long political process, and by now it has developed considerable depth to its institutional processes to replicate domestic policy choices and domestic politics, often by integrating EU processes and policies into national politics. While the EU will not be easily replicated and represent the only significantly supranational model so far, it can provide useful lessons in governance and institutional change in international finance. The EMU, for example, has meant member central banks and treasuries had to give up all autonomy in monetary policy. One might set out to determine under which conditions increased monetary and financial integration has been associated with productive institutional changes leading to better regulation and supervision and enhanced stability. Also in other financial services areas, the EU has been debating how best to balance changes and harmonisation in rules with institutional changes, like home supervision. More generally, what has been the impact of the shifts in balance between national and supranational or international agencies and the increased financial integration on national authorities' decisionmaking in the EU or other regional arrangements? Have substitute arrangements

[13] See Soederberg (2002) for an analysis of the FSF and the G-20. Other possible arrangements to analyse include: How did the Basel II process come about? What was the role of the private sector in the design of Basel II? What was the role of various groups of countries, developed/developing countries? (See Claessens, Underhill and Zhang, 2003, for some analysis.) Idem for the SDRM: what was the role of the private sector in affecting the outcome, why was there no eventual agreement? Or what motivated the change in the recent decade at the IMF in terms of more openness and more scrutiny, including having its own independent evaluation department? Has it meant different decisionmaking processes? Or what has triggered the private sector to come up with rules, are these good rules, when does it work and when not? A new Code of Conduct, for example, is being designed on dealing with financial crises. Or regarding global efforts currently underway on having firms from developed countries provide more transparency aimed at reducing corruption, but being resisted by selected interests, e.g. oil companies. What are the political economy circumstances that allow this to happen? Do these efforts reflect private market interests only or do they have a public policy value?

emerged? One of the areas where little progress has been made is in the lender of last resort, which was once the responsibility and in practical terms lay within the capacity of national authorities. The unification of monetary policy and the intensified integration of EU financial markets imply these arrangements no longer apply. Why is it that this area has been so more difficult and what does this suggests for efforts on establishing a lender of last resort at the global level?

There are also historical lessons on some of these issues, including from federalisation in countries such as the US and Mexico. In the US, some have argued that the competition for capital has led individual states of the union to offer relatively strong property rights. The key to the successful race to the top was a common federal structure in which freedom of movement of capital and labour was assured. Lessons from Mexico suggest that a federal structure does not always deliver this, because there also needs to be institutionalised political competition among states (Haber, 2004).

There are similarities here with the debate on race to the top or to the bottom in the context of financial competition among states and countries. It has been argued, for example, that the ability of US corporations to incorporate in the state of their choice (often Delaware) led in some regards to lower standards corporate governance because as it has allowed for more entrenched management by facilitating various takeover protections (Bebchuk and Cohen, 2003). Others have argued that this form of competition has led to improved corporate governance and better firm functioning (Romano, 2005). Yet, others again have argued that only the intervention by the federal state has restrained individual states from offering worse environments and triggering a race to the bottom (Roe, 2003). When does federalism deliver which results?

Of course, if the analogy is to work at the international level, we need to consider competition among sovereign countries rather than units of a federation and how competition for capital among these units compares to the current internationalisation of financial services. Again, the EU might provide some lessons here. In some areas like banking, the EU has chosen a model of minimum harmonisation and subsidiarity, with free competition, whereas in the area of securities markets more uniform standards are being sought. What explains the difference in approaches? Is banking a more local activity than capital markets and thus less in need of uniform rules (unlikely)? Was this indeed the optimal arrangement balancing issues of efficiency and effectiveness? Or is banking less transparent and more subject to preferential treatment by government of local champions and is full harmonisation therefore less desirable from a political, rather than economic perspective? To what extent do EU members actually compete over policy, or was there a broader, transnational consensus among the associated actors in the process? Is it the case, because competition among individual countries largely takes place in financial markets (e.g. through "beauty contests"), that it leads to the maximisation of private interests? Are there forums where (collections of) countries compete mainly in terms of public interests?

3.4 Towards a More Political Economy Approach?

As pointed out at the outset of this chapter, the tensions between the achievement of global and national development objectives in a world of fragmented governance, multiple institutions, accelerated financial integration and increased private sector roles need to be better understood, and we are just at the beginning of this analysis. To understand these relationships and what to do about them, it is clear though that one needs to more fully consider both the political and economic dynamics at the national and international levels.

One needs to begin by clearly identifying the incentive structures of both markets and policymaking institutions, and how they simultaneously contribute to the integration of financial markets and many of the policy dilemmas we have identified. By beginning with the preferences of actors, one can begin to understand the pressures for change. One then needs to understand how these preferences emerge from particular institutional and market and institutional settings. By setting the preferences of actors in their context of the markets and the institutionalised policy processes of the state and international regimes, one can hope to better understand how actors compete simultaneously for both political and economic resources in order to shape their environment in their own image or interest. This helps to clarify the inherent endogeneity of most variables contributing to the eventual dynamic outcome. While parts of this chain have been analysed, the full process is yet unclear.

4 Legitimacy of the International Financial System

Finally, there are issues of how policy processes and institutions at the global level might become more accountable and outcomes more legitimate in relation to the policy preferences of citizens of all economies, in particular the developing world. This concerns both the compatibility of any global financial architecture with national economic development aspirations and political processes as well as the bonding value derived from the international system. Here the question of power differentials competes with issues of representation. What is legitimate for the powerful, based on the shareholder principle, is not always representative, and therefore legitimate, for those most likely to be affected by the decisions taken. Furthermore, as was pointed out in Section 3 above, forms of representation should respect preference formation at national and regional levels. If such forms of representation not only stimulate legitimacy, but also serve as catalysts for broader and more successful international development processes, the economic benefits for all are not difficult to demonstrate. Let us remember that the "democratisation" of western European economic development processes in the post-war period was also accompanied by the most astounding improvement in economic performance. Representation and efficiency need not work against each other.

In the eyes of some, the international financial system has been undergoing an identity crisis. The failure to deliver on many of the goals set out by international development agencies, the debt problems of low-income countries, the difficulties in crisis management, among others, all raise questions in the eyes of the general public on the validity of the international organisations involved. The agencies and the system more broadly are seen as failing to prevent or otherwise successfully confront the major challenges they were supposed to address, especially the setbacks to the development process represented by persistent financial crisis. Of course, this is not the only point of view. Where developed countries are concerned, the international financial system has performed relatively well in the last three decades. For example, the system has done well in terms of dealing with large structural changes and has not faced the type of 1971-73 crisis associated with the breakdown of Bretton Woods. Nonetheless if we are to assess outcomes in terms of representation and in relation to fairly simple notions of political legitimacy, clearly the decisions of a minority of the powerful, the shareholder principle, has prevailed and has imposed important costs upon those poorly represented in global financial governance.

The different perceptions can in part be attributed to changes in the world. One can make a case that developments have been forcing changes on international organisations for which they were not well equipped because their original mandates were different. Institutions like the IMF and World Bank responded to the changes in part by broadening their agendas and taking on issues such as (global) environmental performance, socio-demographic issues, and more generally pursuing a more complex vision of the development process, relying in part more on private sector activities. As part of this, they became more open and participatory in their decisionmaking, making their relationships with client countries, donors and other agents (like NGOs) more complex and risking (greater) client capture. It has also made it more difficult for them to explain their usefulness to their shareholders and other stakeholders, all the more so since they lost their traditional tools in part. A vicious circle of ever more responsibilities and subsequent failure to meet expectations for many of them resulted in even deeper legitimacy crises for some agencies. Furthermore, one might argue, we could not expect IFIs to change faster than their (more powerful) members. But this account fails to bring in the role of private interests in the policy process as discussed above, and how private preferences have considerably reinforced the instincts of the creditor countries in international institutions.

Many of the other international financial agencies and organisations – such as the BIS, the Basel Committees, the FSF, etc. – do not operate in the public eye as the Fund and the Bank do, and as such they do not face similar goal and legitimacy crises in the eyes of their members. It is national authorities in the first instance that address their functioning, including the legitimacy of their policies in relation to domestic political processes. Yet, they are not immune to problems of legitimacy in a broader sense. The lines of accountability to national authorities of an institution such as the Basel Committee, let alone to parliamentary scrutiny, are less clear than their association with their private interest interlocutors. They may appear to redress the balance between self-regulation and sufficient public oversight of the global financial system, but the rules they promulgate are remarkably in line with private sector preferences.

They fail a legitimacy test in another respect. Even if one were to accept that they are fully accountable to national policy processes, the decisions that they take affect a far wider public than their G-7/G-10 "shareholders". Legitimacy of the international financial system thus needs to be conceptualised more broadly, relative to the often-contrasting interests of the many developed and developing economies in the world today. To whom should the system be accountable, and in whose eyes and for what purposes should the system be legitimate? It may be helpful to think in terms of the standard categories of input and output legitimacy (Scharpf, 1999) where input aspects of legitimacy have to do with the legitimacy of the process, and the output side concerns the legitimacy of the outcome. In the developed countries, private interests and public agencies dominate the input side regarding the international financial system. Consequently, it is not surprising that the outcome is relatively satisfactory to developed country governments and (despite some protests) largely to their public. However, the process (input) is singularly unrepresentative of developing country interests, and it is not surprising that such a process leads to an outcome that is often incongruous with the broader objectives of economic development. Why should developing country preferences not be equally well represented, so that international norms are compatible with national political and economic dynamics, and not the other way around?

Solutions may have to be found in building regional coalitions among developing countries and moving away from individual assessment by markets and international financial institutions to representation and assessment of collective interests. One such example was the role of a number of developing countries in the Doha Round of trade negotiations, where they steered towards outcomes much more favourable to developing countries. Another example is NEPAD (New Partnership for Africa's Development), which relies, among other things, on countries designing their own reform programmes and on extensive peer monitoring. Such mechanisms may discourage downward "policy competition" among countries, increase regional representation and rebalance power away from the "centre". Another mechanism is the financial support provided by the UK and Dutch development ministries to the executive directors in the IMF and World Bank that will help increase their "voice."

5 Conclusions

There is little doubt that the interests of developed countries predominate in current global financial governance processes, via the "shareholder principle." Financial globalisation has also involved a change in the balance of power between public authorities and private interests in international monetary and financial policies. This begins at the national level in developed countries where financial services policymaking is characterised by low transparency and national central banks have traditionally had close and relatively exclusive relationships with banks and other financial institutions at the national level. As national authorities have taken on market liberalising policies closer to private sector preferences, this situation has become increasingly extended to financial governance at the global level, where the private interests of developed country financial institutions are increasingly evident. Given this closeness of public and private actors and their shared interests in the policy process, it is not surprising that private interests are predominant in determining rules and outcomes in domestic financial systems.

How the private sector gains this stake varies by economy. In developed countries, closed-circuit lobbying or even regulatory capture may occur, not breaching formal laws but undermining broader public policy objectives. In developing countries, more overt forms of corruption may be more common, e.g. banking licenses up "for sale." It is not just the static effects that matter. Many reform and adjustment programmes have faltered because of misjudgements about the dynamics of liberalisation and privatisation, which are related to political economy factors. For example, few foresaw that the dynamics of mass privatisation in transition economies would leave little or no constituency for improving the institutional environment. Few foresaw how private financial interests would commandeer state-initiated liberalisation processes, undermining the necessary adaptation of financial supervision to the new market forces, which was a crucial ingredient of the Asian Crisis. In many countries, a call for more securities markets regulation and supervision was ignored since insiders captured legislators and regulators.

Global financial governance also has faced such issues. At the international level, private banks have clearly played a major role in pushing for cross-border liberalisation in both developed and developing countries. Their influence operated through both national and IFI policies to this effect. As cross-border liberalisation began some two decades ago, the effectiveness of regulation at the national level was diluted, but the jurisdictions of state agencies remained constrained to the national level. Cross-border cooperation and supervision has been, as always, difficult and slow to emerge and tended to be crisis-led. Private interests were much quicker to regroup in coherent coalitions at the international level, pushing their preference for "governance light." At the level of global financial governance, developing countries face the power of both public and private agencies of developed countries, often in coalition with each other. Geopolitical and other factors add extra complications to the problem. The resulting lack of financial and other regulation at the international level in line with broader national development goals has left more space for the private sector to promote its own interests.

In many developing countries, foreign financial institutions from developed economies have had a large role in domestic financial markets and have been able to "threaten" national agencies, thus gaining a stronger voice than the local constituents of the "public interest" behind the national policy agenda. This has been pursued either directly at the local level, or by using the home developed-country state in bilateral negotiations, or indirectly through the conditionality and debt workout terms pursued by IFIs and determined by (home) developed country shareholder power favourable to private interests. Global arrangements such as the Basel Committee and other standard-setting bodies dominated by developed countries have aggravated matters by furthering overseas private sector interests to the potential detriment of local needs in developing countries.

In the eyes of some, and as a reflection of these governance weaknesses, the international financial system has been undergoing an identity crisis. This assessment of course varies according to perspective. The early experiences of developed countries with liberalisation were fraught with difficulty. Most underwent serious national banking crises (e.g. Scandinavia, the US), and the growth of cross-border markets produced international crises such as the Franklin National/Bankhaus Herstatt (1974), Banco Ambrosiano (1982), the post-1982 Latin American debt crisis, BCCI (1992), or the Barings incidents where contagion risked the downfall of the system. Since the early 1990s, the international financial system has performed relatively well for these countries. For the rest of the world, the view is different.

The failure to deliver on many of the goals set out by the international development community, the debt problems of low-income countries, the setbacks to the development process represented by persistent financial crises, and the continuing difficulties with debt workout and the crisis management framework, all raise questions about the effectiveness and eventual legitimacy of international financial governance and of the organisations involved. While some observers may assess the international financial system in a positive light, we nonetheless need to assess outcomes in relation to representation in decisionmaking processes and to the legitimacy of the outcomes. Clearly, the shareholder principle has prevailed and has imposed important costs upon those poorly represented in global financial governance. This principle correctly gives voice to the wealthy, but it allows substantially reduced input to those most affected by the decisions themselves.

These serious deficiencies in the governance of the international financial system point to the need for reform. Fundamental issues of political economy are at stake: the role of publicly accountable institutions versus the private sector at both national and global levels; the balance of power between core and periphery countries in the global economy; the tensions between national (in particular developmental) and global system-level imperatives; the relative influence of citizens in national and world affairs; and the legitimacy of both national and global institutions. Many of these questions have been around for a long time (going back to Smith, Marx, or Prebisch), and have been the root of intense past and current debate (e.g. how to avoid a democratic deficit in the EU). They are far from easy to resolve. Nonetheless, if development policies prove consistently ineffective, the legitimacy of national instances will remain impaired, exacerbating the problem and making new initiatives even more difficult. Furthermore, if global level decisions based on the shareholder principle clash systematically with development objectives set in a context of emerging national democratic processes, the legitimacy of global governance will be in question from the ground up. If the weak are only heard when their opposition can no longer be ignored, it is probably too late to come to a workable compromise solution. Surely, anticipation is not beyond human capacity.

We argue therefore that greater attention to issues of legitimacy and accountability is likely to generate financial governance more in line with broad international development imperatives. Furthermore, a better understanding of the role of private interests in the current process of cooperation in global financial governance will lead to a better understanding of not only the problems of the system, but also of how to resolve them. In each section, we have identified insufficiently addressed research issues, which can be tackled through advances in economic and political economy research tools, and with the benefit of more data.

Our main conclusion though is that one must take problems of governance and legitimacy as starting points, not afterthoughts. The legitimacy of the international financial system needs to be conceptualised more broadly, relative to the often-contrasting interests of the many developed and developing economies in the world today. To whom should the system be accountable, and in whose eyes and for what purposes should the system be legitimate?

Long-run developmental successes such as those in East Asia are, after all, against the interests of no one. Solutions will not be easy and may have to be found in building regional coalitions among developing countries and moving away from the assessment of policies by markets and international financial institutions, toward representation and assessment of collective interests. One such example was the push by a number of developing countries in the Doha Round of trade negotiations towards outcomes much more favourable to themselves. Another example is NEPAD (New Partnership for Africa's Development), which relies on countries designing their own reform programmes and on extensive peer monitoring among other things. Such mechanisms may discourage downward "policy competition" among countries, increase regional representation and rebalance power away from the "centre". We hope that more progress like these can be made for which further research can help.

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