



Special Report - The World Crisis

IDEAS Special Report

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Cover Image

President Barack Obama feels the strain (AP Photo) as world markets continue to tumble (data from FT.com)

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Introduction - The World Crisis

In his latest book published right at the beginning of 2008, George Soros observed that the world was “in the midst of the worst financial crisis since the 1930s”. At one level of course Soros was right. Indeed, as he went on to point out in almost excruciatingly painful detail, the financial crisis of which he spoke could be traced back to one single ‘tipping point’ month - August 2007 - when on the 6th American Home Mortgage filed for bankruptcy, followed on the 7th by the suspension of three investment funds run by the French Bank BNP Paribas, on the 10th and 13th when the European Central Bank pumped over 100 billion Euros into the banking system and money markets, and on the 17th when the Federal Reserve moved fast to cut the discount rate.



Still, even the shrewd Soros (a former student of the LSE) could not have foreseen what followed. In fact, for one so often attacked for being too alarmist in the past, Soros was actually not alarmist enough and managed to get the crisis wrong in at least two very important respects.

First, the world was not - as we have since discovered - in the midst of a crisis as he implied but rather only just at the beginning of one; and a year on from when he wrote, it was fast becoming obvious that it would not just last for a few weeks or months but almost certainly for years.. Secondly, though the crisis itself may have begun in the financial sector - hence its original designation as a ‘credit crunch’ - it rapidly spread to what is sometimes euphemistically termed the ‘real’ world economy, nowhere more catastrophically than in the country where the original crisis had begun: the United States. Here the pace of economic decline, and with it a collapse in confidence in the American economic system was by any measure extraordinary. Nor were things any better across the Pacific. Indeed, for Japan (still the second largest economy in the world in spite of China’s much-vaunted ‘rise’) the outlook was much worse and over a three month period between September 2008 and early 2009 it underwent a slump that set its economy back nearly 25 years - and this after a decade long slowdown during the 1990s that had already put paid to the always exaggerated idea that Japan might one day overtake the West.

The situation was no better in Europe or the UK. If anything things were just as critical, most ominously perhaps in Britain where dependency on the housing market and the financial sector made it especially vulnerable. The prospects for other European economies were not much better; indeed in some like Iceland, Ireland and those of Central and East Europe, they were a good deal worse. Even the so-called BRICs did not escape the storm. Certainly the virus-like character of the crisis has put paid to one myth amongst many others: namely that the emerging economies would remain relatively free of the economic problems facing the rest of the world. With unemployment rising rapidly in China and the collapse in oil prices putting paid to Russia’s ambitions, there were few subscribers any longer to the notion that some parts of the international economy could remain aloof - or in the jargon ‘decoupled’ - from what was unfolding in the United States and Europe.



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The scale, the speed, the geographical spread, and perhaps above all, the almost complete failure of policy-makers and leading economists alike to see the possibility of such a crisis ever taking place – though some very unpopular ‘whistleblowers’ had more than an inkling that the system was not viable – has forced everybody everywhere to rethink old assumptions and cast out traditional truths about the way in which states and the international community do and should ‘do’ economics. But they had better think fast as our three contributors to this forum suggest. With globalisation as described by Danny Quah now under threat, and the stability of a number of countries now in question, there is little time left to prevent the current crisis – whose gravity according to Howard Davies should not be understated – from turning into a slump. We can only hope along with David Held and Kevin Young that the world grasps the nettle and addresses the profound weaknesses that the current crisis have exposed in the structure of global governance. Whether it will, and indeed whether this will prevent things from getting a lot worse, remains to be seen.

Versions of the papers contained in this Special Report were presented at the “New World, New Capitalism” conference held in Paris in January 2009, organized and hosted by the French government. French President Nicholas Sarkozy set the tone for the meeting as he called on Old Europe to lead the discussions on the new world economy as a “narrative of the future”, and to re-found capitalism because “if we don’t do it, others will do it in our place”. It is likely that the “others” he had in mind were those having meetings and working groups in Washington DC and New York; in fact, it was striking that the “American” view of capitalism presented in Paris remained clearly opposed to regulation and state intervention.

Europe did have something different to offer, and three specifically European themes emerged from the debate. First, the state would be the only viable filter and guarantor for social justice. Second, the presence of labour unions in the debate was highly symbolic of the European trend to include “social partners”. Indeed, as this crisis has grown, labour unions and “workers” have reemerged onto the radar of economic and social policy. Third, the future lay with multilateralism.

Indeed, Europe’s new message could be understood as “enough of one-currency domination, would the dollar please make room for the euro”. That the non-Western world was underrepresented in Paris despite the organizers’ efforts to bring Africa, Asia and Latin America to the table is perhaps symptomatic of a response to a crisis that although truly global in scope has yet to embrace globalism.

“Comment peut-on réguler le capitalisme”

It is difficult to overstate the gravity of the financial and economic crisis which the world now faces. Almost all the developed economies are now in recession, or on the edge of it, and the most recent economic indicators suggest that this recession will be more severe than any experienced since the Second World War. While the major emerging markets like China and India continue to grow, they are also slowing down quickly. So the world faces the prospect of outright recession in developed economies and significantly below trend growth elsewhere. The consequence will be rising unemployment everywhere, with the associated social and political tensions. The global growth dynamic which has lifted many of the world's poorest people out of poverty over the last 20 years has stalled.



The crisis is so serious that it clearly justifies fundamental re-thinking about the way in which national governments, and the international institutions to which they are affiliated, carry out their tasks of overseeing the global economy and, particularly, of regulating financial markets.

THE CRISIS AND ITS CAUSES

Arguably we are still too close to the origins of the crisis to develop a fully articulated theory of why and how it emerged. A good and careful explanation of the origins of the financial crisis, which summarizes our current understanding, can be found in a paper published in November 2008 by the Brookings Institution.¹ The authors' summary is that:

“The financial crisis.... had its origins in an asset price bubble that interacted with new kinds of financial innovations; with companies that failed to follow their own risk management procedures; and with regulators and supervisors that failed to restrain excessive risk taking”.

It now seems clear that following the recovery from the dotcom bubble at the beginning of this century monetary conditions and liquidity became very loose. That in turn contributed to a bidding down of risk premia, so that investors were investing in risky assets at returns which did not reflect the uncertainties behind those investments.

Why was liquidity so loose? That remains highly disputed territory. Some argue that the principal failure was that the monetary policies failed to restrain liquidity growth, what one commentator has called “the great failure of central banking”.² Others argue that interest rate policy was not obviously too lax, but that regulators failed to require banks, in particular, to retain adequate reserves

¹ The Origins of the Financial Crisis. Baily, Litan and Johnson. Brookings Institution Initiative on Business and Public Policy. Fixing Finance Series – Paper 3. November 2008.

² The Great Failure of Central Banking. Stephen Roach, Fortune. September 2007



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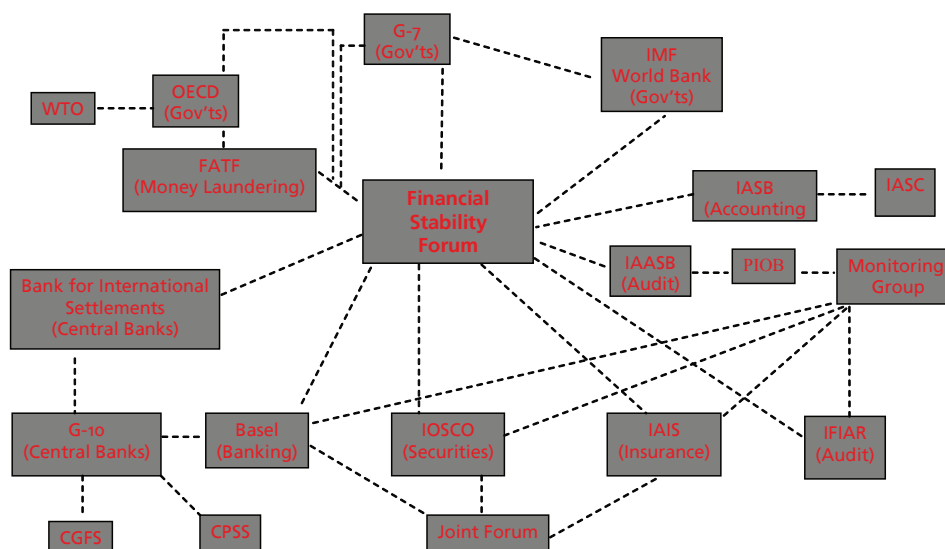
in the upturn, to protect them against losses in the downturn. In other words, regulatory policy was pro – rather than counter cyclical.

A further strand of analysis maintains that the underlying cause can be found in the so-called “global imbalances”. Some Western economies, notably those in Anglo-Saxon countries, were over-consuming. In both the US and the UK household debt as a percentage of GDP rose to previously unheard of levels, and savings rates fell close to zero in both cases. At the other extreme the savings rate in China reached 40% GDP. China’s huge trade surplus was balanced by enormous trade deficits in the US and some other countries. Many economists argued that these imbalances could not persist, though most believed that the unwinding would be less dramatic and less damaging than it is turning out to be. The central issue here is the extent to which the crisis has revealed flaws in the international regulatory architecture, flaws which must be corrected if we wish to reduce the risk of similarly damaging crises emerging in the future.

INTERNATIONAL FINANCIAL REGULATION

The “system”, if it can be described as such, which oversees international financial markets is certainly more a product of evolution than of intelligent design. It is based on a delicate balance between supranational entities and national governments. Unlike in the trade arena, where countries sign up to international agreements in the WTO, and cede jurisdiction over the policing of those agreements to a supranational body, in the financial arena there is no such model in place. The international bodies which do exist to set global rules, for example the Basel Committee which sets capital reserve ratios for banks, depend on voluntary agreements by their members, who commit to implementing those agreements in their home countries on a “best endeavours” basis. There are no multilateral sanctions on those who do not follow those agreements. (The main enforcement mechanism is that

Global Committee Structure - A Regulator’s View



Source: Adapted with permission from Sloan and Fitzpatrick ‘The Structure of International Market Regulation’, in *Financial Markets and Exchanges Law*, OUP, 2007

countries may refuse to allow banks which do not meet international standards to set up branches there. But this is a difficult sanction to apply in the face of political pressure).

Furthermore, the system is built on an old fashioned subdivision of financial markets into three sectors: banking, securities, and insurance, which no longer reflects the reality of international financial markets. The result of that three-legged arrangement, combined with the existence of a wide-range of international bodies with different and overlapping responsibilities, is a highly complicated network of institutions and committees which lack obvious logic and structure. The system as it currently stands has been described in "Global Financial Regulation: The Essential Guide" by Davies and Green.³ The simplified picture of the global network can be found at Exhibit A.

One striking feature of the organisation chart in Exhibit A is that all the boxes are connected by dotted lines. In other words, there are no obvious hierarchical relationships between the different groupings. While the G7 Finance Ministers have, in theory, sat at the top of this pyramid in recent years, they have not taken an active and interventionist role in financial regulation, taking up individual issues typically only in crisis conditions. One consequence is that the system has responded very slowly, if at all, to changing circumstances in financial markets. For example, the Basel accord on bank capital was diagnosed as inadequate in the mid 1990s. It took 10 years to devise Basel 2 which was instantly redundant at the point it was introduced in 2008. Indeed the Federal Reserve has not yet switched to Basel 2 and may never do so.

The roles of the international financial institutions, the IMF and the World Bank, in this structure are also somewhat unclear. The principal functions of the IMF and the World Bank are to monitor compliance with international codes and standards, on the one hand, and to assist countries to meet those standards on the other. In addition, the IMF in particular is charged with monitoring global financial stability. The BIS performs a similar function in parallel. Both of them, in different ways, produced warnings about global imbalances and financial risk taking in the years leading up to the "explosion" in the summer of 2007. But those warnings were not hard wired into the regulatory system, and produced no concrete consequences in the form of tighter capital regulation. A good description of the pre-crisis analyses can be found in the Annual Reports of the Bank for International Settlements in 2007 and 2008.⁴

These weaknesses in the regulatory architecture have now been well understood by governments across the world. They were at the heart of the agenda for the G20 Summit in November 2008 in Washington. The fact that the Summit was convened on a G20 basis pointed to another problem: the unrepresentative nature of the bodies regulating the international financial system, whose composition reflected the financial world as it used to be, not as it now is. One early decision by that Summit was that the key institutions and committees must be re-balanced to bring the new financial powers into the core decision making processes. The Summit also set in train a number of work streams on detailed regulatory issues which will produce recommendations in time for the second G20 Financial Summit in London in April 2009.⁵

But there is a danger that this detailed work may mask some of the fundamental issues which now need to be addressed by both political and economic decision makers. This paper argues that there are 7 interlocking sets of issues which, together, shape the debate.

3 Global Financial Regulation: The Essential Guide. Howard Davies and David Green. Polity Press 2008.

4 www.bis.org

5 Declaration of the Summit on Financial Markets and the Real Economy. 15 November 2008.

KEY ISSUES TO ADDRESS

1. THE ROLE OF MARKETS

In an unusual mea culpa Alan Greenspan said before Congress that his main failure had been to place excess reliance on the ability of the management and shareholders of major financial firms to act effectively in their own interests. "I made a mistake in presuming that the self-interest of organisations, specifically banks and others, was such that they were best capable of protecting their own interests".⁶ Is the Greenspan diagnosis correct, and has the crisis revealed fundamental flaws in the market mechanism? Have financial instruments become too complex for even those who invest in trade in them to understand the risks to which they are exposed? Are there fundamental flaws in the intellectual framework which market participants use to try to understand financial market dynamics – the efficient market hypothesis and its intellectual descendants? If there are such weaknesses, how should they be corrected? Are different forms of governance required for financial institutions if the traditional principal/agent model does not deliver satisfactory outcomes?

An alternative, though perhaps complementary hypothesis is that the fundamental problem lies in the way in which states seek to regulate markets.

2. THE FUTURE ROLE OF THE STATE

For years it has been fashionable, certainly in the major financial markets of London and New York, to downplay and even denigrate the role of the state in financial markets. Regulators were widely considered to be a tiresome inconvenience, at best, and central banks were often seen as monetary policy authorities only. Even in the months leading up to the outbreak of the crisis, financial firms thought the major risk to their business was "excess regulation".⁷ But we have now seen that in crisis conditions financial markets, and the main institutions within them, depend entirely on the state for their continued existence. Almost all the major financial institutions of the Western world would have collapsed without the provision of huge sums of liquidity by the central banks, and many of them now owe their survival to direct capital injections by the governments, and to the expansion and strengthening of government-based deposit guarantee schemes which have prevented retail bank runs.

It is once again understood that financial markets, and especially banks, depend on the existence of what Paul Tucker of the Bank of England has described as a complex "social contract" between them and the state.⁸ Banks undertake the fundamentally risky process of maturity transformation, turning sight deposits into long term loans. They could not do so on the scale needed to support a dynamic economy without two essential underpinnings: a deposit guarantee scheme (whether funded by the banks themselves or not is less crucial than the fact that it is underpinned by statute) and the availability at times of stress of potentially unlimited liquidity from the central bank. Those two aspects of state support allow the banks to take risks. But the state cannot allow unlimited risk-taking. Otherwise, banks would have little incentive to control their risks as when things go well they will make high profits and when the market turns down the tax payer will bail them out. So, to exert some control over risk-taking governments impose prudential regulation on the banking system which imposes a requirement on banks to hold capital reserves at a certain level.

6 Testimony to the House Representative Oversight Committee. 23 October 2008

7 Banking Banana Skins 2006. David Lascelles. Centre for the Study of Financial Innovation. www.csfi.org

8 Remarks by Paul Tucker at a Chatham House Conference on "The New Financial Frontiers" 29 April 2008. www.bankofengland.co.uk

It is now clear that all elements of this “social contract” need to be re-thought. Deposit-guarantee schemes have not been generous enough to prevent bank runs. The normal ways in which central banks provide liquidity to the system have proved wanting and had to have been revised several times during the crisis. Prudential regulation has failed adequately to constrain risk-taking. The intensity of that regulation will clearly have to be stepped up in the future. To do so will, however, be costly. Requiring banks to hold higher reserves, and more liquidity, will impose costs on them which will be passed on to customers. So governments cannot with impunity make their banking systems “safe”. That will in turn constrain economic growth. Determining where the new balance should be struck will be a very delicate process.

Robert Solow, the 1987 Economics Nobel prize-winner, argues for a fundamental change: “I would like to see a regulatory system aimed at insulating the real economy from financial innovations insofar as that is possible. That may require limits on the freedom of actions of commercial banks”.⁹

And there are even more serious problems to address under this heading. Some governments, notably in the US and the UK, now have sizable shareholdings in some of their banks. Is it desirable that the state should hold equity stakes in banks? International experience would suggest that state owned banks are often inefficient and loss-making. But having taken an equity stake, how easy will it be to withdraw, and on what terms should the government withdraw? While the Government does own a stake in a bank, what influence should it have on the bank’s lending policies, and on its remuneration? Some of these, perhaps, are short term questions, but there is an urgent need for a coherent intellectual framework within which to address them.

3. BALANCING LEGITIMACY AND EFFICIENCY

It is now widely accepted, certainly by the G20 Summit, that the legitimacy of the international regulatory bodies needs to be strengthened, in other words new members from the major developing countries must be included. But we know from experience that broader membership of international bodies can lead to inefficiency and stasis. Committees with 150 members will rarely make decisions. How will that balance be struck in the future? Which emerging markets need to be brought in? How to choose between them? Do G7 countries themselves need to reduce or consolidate their own representation? Why, for example, can the EU not be represented by one voice?

4. THE GLOBAL/NATIONAL BALANCE

Some have argued that repeated malfunctions in the international financial system point to the need for a global regulator, perhaps a world financial authority.¹⁰ So far nation states have not been prepared to cede authority over their financial systems to a global body, however governed. This position contrasts markedly with the arrangements for international trade, where the WTO is able to enforce trade agreements. Does the latest crisis alter the balance of argument on this central question? Might there be a case for some kind of supranational authority with an enforcement arm, to ensure that countries meet internationally agreed standards on a continuing basis? Might nation states gain sovereignty in one sense, by ceding responsibility to a body which can conduct global oversight more effectively than any individual state?

⁹ Interview with the Financial Times. 16 December 2008

¹⁰ Global Finance at Risk. The Case for International Regulation. John Eatwell and Lance Taylor. Polity Press 2000

5. INTERNATIONAL REGULATORY INSTITUTIONS

The crisis has focused attention on the continuing uncertainty about the appropriate role for the International Monetary Fund in particular. Should the IMF itself become a kind of financial regulator? At present its role is limited to a general financial stability oversight function, together with some monitoring of compliance with international standards. Should the IMF take over more responsibility in this area, or is the Financial Stability Forum, with its broader membership including regulators in nation states themselves, a more appropriate body?

There is a particularly difficult version of this question within the European Union. The decision making structures of the EU in relation to financial markets are, if anything, more complex than those which operate globally. (Exhibit B). Although the single financial market has been in operation for over 15 years, and financial firms authorised in one country can operate across the European economic area, the crisis has revealed incompatibilities in the domestic regulation of banks which has caused serious problems elsewhere. The most dramatic example is the problems created in the UK and the Netherlands by Icelandic banks, using an authorisation in Reykjavik to bid aggressively for deposits from retail savers. When those banks ran into difficulty, the Icelandic Central Bank was unable to back them and the British Government had to step in. Can this and other problems in Europe be resolved without the creation of a single regulatory authority in the European Union to sit alongside European Central Bank? Without such a body, is there not a risk that the single financial market process will go into reverse, with – as has happened at times during the crisis – individual countries pursuing “beggar my neighbour” policies to protect their domestic institutions? Are we about to see the single financial market go into reverse, with EU member states asserting jurisdiction over local entities of firms head-quartered elsewhere in the EU?

In a recent report for the Centre of European Policy Studies Karel Lannoo has argued that the EU should now establish a European Financial Institute, on the model of the European Monetary Institute which was the forerunner of the European Central Bank. The EFI should set out a roadmap for the creation of new central authorities for the regulation of major pan-European institutions at least.¹¹ The EU have asked a “wise men” group, under Jacques Delarosière, to explore the future of European regulation.

6. HOW “TOUGH” SHOULD REGULATION BECOME?

It is easy in the midst of a crisis created by exaggerated risk-taking in the financial sector to argue that regulation must be tightened for the future. But, as we have pointed out, tighter regulation is not costless. It comes with a high price tag for firms and consumers in the form of raised costs of borrowing. How do we determine where to set the balance in future between financial stability and risk taking?

In the case of insurance companies, as with banks, there are similar issues related to solvency. Tighter solvency rules look attractive, but will significantly reduce the returns for long term investors. And in securities markets countries have variously intervened to prevent short-selling and in some cases leveraged trading, in stressed market conditions. But those restrictions are likely to have adverse long term consequences for the cost of capital. Again, determining where the balance should be struck will be a delicate question in the future.

¹¹ Concrete Steps Towards More Integrated Financial Oversight: The EU's Policy Response to the Crisis. Karel Lannoo. Centre for European Policy Studies. 1 December 2008. www.ceps.eu

7. THE BORDERS OF REGULATION

The fundamental justification for prudential regulation of institutions has remained broadly unchanged for some time. Governments typically regulate investment managers or deposit takers who receive funds from retail investors or depositors. They apply lesser regulation to investment banks who operate principally in the wholesale markets, and institutions investing entirely on behalf of professional investors or institutions, like hedge funds or private equity firms, have been largely outside the regulatory framework. Certainly they have not been subject to capital regulation. But in the midst of the crisis some important changes have been made to what we might call the “regulatory frontier”. Specifically, the main US investment banks have become bank holding companies, able to take retail deposits and with privileged access to the Federal Reserve. It is likely that, as a consequence, those investment banks will be able to take fewer risks than before, and their leverage will be significantly reduced. As a result proprietary trading activities are migrating from those institutions into unregulated hedge funds. In those circumstances, is the regulatory frontier now in the right place? Should hedge funds, and perhaps the major private equity firms, be subject to greater regulatory oversight, if it is possible that their activities will be on such a scale in the future as to generate risks for the financial system as a whole?

Another set of institutions which have been broadly outside the regulatory net are credit rating agencies. There are new legislative proposals in the European Union to impose a European regulatory framework on those agencies. But does it make sense for there to be different regulatory structures in the European Union and the US on essentially the same firms? Would it not be preferable to reach a global agreement on where the regulatory frontier should be drawn?

CONCLUSION

The crisis has challenged many of the assumptions which have underpinned the regulatory system. The consequences of the financial meltdown will increasingly affect ordinary working people over the coming months. That in turn, will focus political attention, and perhaps popular anger, on actions of the firms and regulators who are seen to be responsible. So the task of re-engineering the system for the future is urgent. And politicians will need a new language to explain their responses to a sceptical public.

Global Financial Governance: Principles of Reform

It is now increasingly acknowledged that complex global processes, from the financial to the ecological, connect the fate of communities across the world. Yet the problem-solving capacity of the existing system of global institutions is in many areas not effective, accountable, or fast enough to resolve current global dilemmas. What has recently been called the paradox of our times refers to the fact that the collective issues we must grapple with are of growing extensity and intensity, and yet the means for addressing them are weak and incomplete.¹ There are a variety of reasons for the



persistence of these problems, but at the most basic level the persistence of this paradox remains an issue of governance. One significant problem in this regard is that a growing number of issues span both the domestic and the international domains. The institutional fragmentation and competition between states can lead to these global issues being addressed in an ad hoc and dissonant manner. A second problem is that even when the global dimension of a problem is acknowledged, there is no clear division of labour among the myriad of international institutions that seek to address them: their functions often overlap, their mandates conflict, and their objectives often become blurred. A third problem is that the existing system of global governance suffers from severe deficits of accountability and inclusion. This problem is especially relevant in regard to how less economically powerful states and, hence, their entire populations, are marginalised or excluded from decision-making.

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

FINANCIAL TURMOIL AND FINANCIAL GOVERNANCE

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

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



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



Figure 1: Dow Jones World Financial Index

All daily available data at close, 12 February 1999 – 12 February 2009

Note: The baseline of 100 is equal to opening value of indexed values at 1 January 1992

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

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

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

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

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

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

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

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

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

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

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

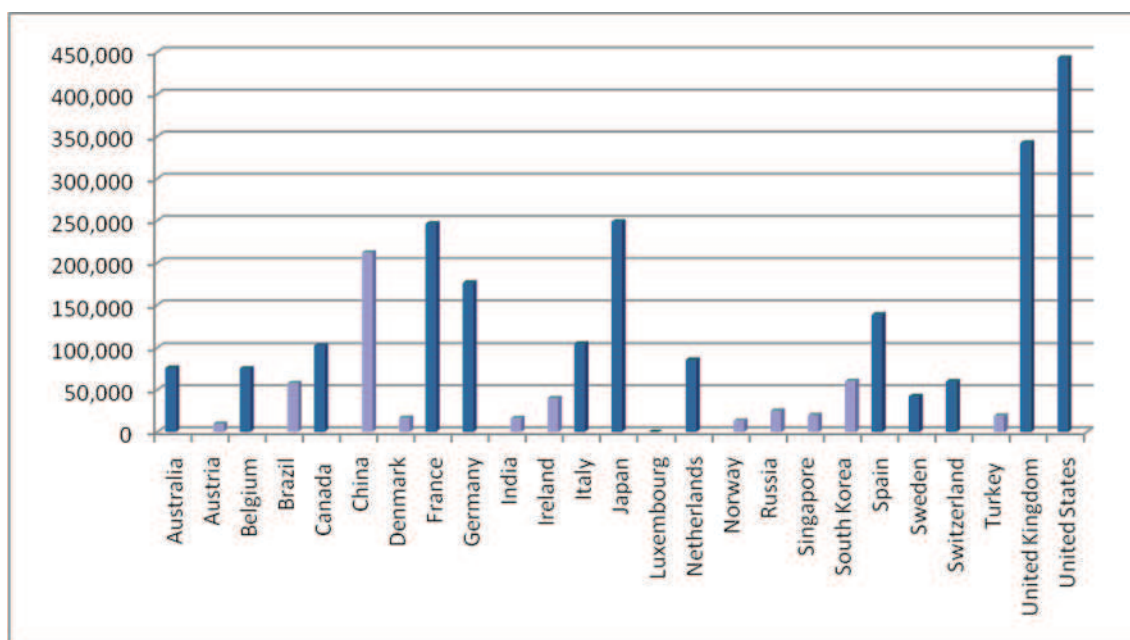


Figure 2: Country Composition of the Largest Banks in the World
 Millions of US Dollars, as of beginning of 2008
 (Lighter shade indicates non-membership in the Basel Committee)

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

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

exclusive group of countries.

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

PRINCIPLES TO GUIDE REFORM

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

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

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

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

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

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

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

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

The Implications of Globalised Finance

The term “globalisation” has survived its first significant sell-by date in modern times. Rightly, it continues to attract policy attention and debate at the very highest levels. Together with just a handful of others—economic growth and inequality, financial crisis, climate change—with all of which it remains inextricably intertwined, only globalisation among economic phenomena has both effects and causes observable from outer space. Its impact on the welfare of humanity is therefore singular. This is even before one considers the sweeping changes in culture and politics that ever greater global integration both requires and engenders.



This article cannot hope to cover the massive body of modern thinking that surrounds globalisation. Instead, what it seeks to do is two-fold: first, flag, with the benefit of hindsight, some of the key background points that any continuing discussion of globalisation needs to keep in mind; and second, offer conjecture where the most likely contentious issues in the near future might be. To keep within space constraints, careful and exhaustive discussion of empirical evidence is omitted. Instead, just the largest salient facts are provided where needed.

THE MECHANICS

Globalisation is the ever greater integration of economic activity across geographical, national, and man-made barriers. Its logic is that of the move from individualistic, self-contained Robinson Crusoe-like economic existence on the one hand, to the exchange of good, services, people and capital, and ideas seamlessly across countries and geography, on the other.

In that shift globalisation has, among much else, brought to consumers worldwide at low cost a previously inconceivable variety of goods, and made available to producers everywhere thriving marketplaces otherwise well beyond their reach.

Globalisation, therefore, most obviously comprises the shipping across countries of massive quantities of steel, aluminium, DVD players, bananas, textiles, coal, and grain. But globalisation is also the offshoring via Internet of insurance claims processing, Powerpoint deck preparation, secondary school mathematics tutoring, and back office computer functions. It comprises foreign direct investment, foreign worker employment (for which total global repatriations already match in value foreign direct investment), and portfolio investment. And, not least, globalisation comprises the value encoded in bitstrings of zeroes and ones coursing across Internet and other media pathways disseminating advertising, knowledge, ideas, and invention across the world.



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Globalisation is therefore driven by two principal proximate factors. First is the secular decline in costs of transportation and communication across the globe. Sea and air shipping, telecommunications, and passenger transportation all have seen dramatic price reduction and productivity gains in the last five decades. The fundamental drivers here are again two-fold: drastic innovation and incremental improvement in technology have now allowed transportation and communication where none were previously possible, or have dramatically improved the efficiency by which goods and services could be transported vast distances. Just as important, the reorganization of firms and businesses and of methods of production has leveraged these technological improvements to disperse operations geographically in the most efficient manner.

The second principal proximate factor underlying globalisation is policy. No technologically-determined inevitability forces nation states to allow their citizens access to ever greater trade, foreign investment, capital flows, immigration, and flows of information and ideas—but to varying degrees this has nonetheless occurred.

Institutions have emerged that attempt in some cases to improve or in others hinder the progress in the ever greater global integration of economic activity. This is to be expected not just from the sheer scale of globalisation—it stands ready to influence the lives of over 6.6 billion humans across hundreds of nation states on the planet—but from the nature of the disruptive changes that it necessarily accompanies.

THE IMPLICATIONS: COSTS AND BENEFITS

A global economic system, even if initially dispersed into just individual self-contained autarkic units, ends up achieving some kind of efficiency in operation. At some point any large enough change disrupts that order and fractures the operations of that global economy into interest groups that stand to gain and others that stand to lose from that disruption.

Globalisation then obviously comes with costs and benefits. The global economic system should continue to embrace globalisation if the benefits outweigh the costs, and not otherwise. The largest potential economic benefits can be reduced to very simple terms: raised economic growth and improved standards of living. But these are no trivial gains. From them, under normal circumstances, flow increased life expectancy and the reduction of disease, hunger, and poverty.

The last statement provides a sobering reminder of what's at stake in this discussion. In developed economies, increased economic growth might be associated with a few percentage point improvements in income. In developing economies, however, containing five-sixths of humanity, economic growth is a matter, literally, of life and death. There, the welfare gains from economic growth are considerable. Any discussion of globalisation that fails to take this into account is just incomplete. The greatest potential economic costs are three: increased income inequality; increased economic and financial instability; increased climate and environmental degradation.

As far as I know, no attempt has yet been made to quantify these largest of costs and benefits in the modern debate on globalisation. Some illustrative numbers, however, are useful.

1. INCOME INEQUALITY

Debate on income inequality in many developed economies has revolved on among other things, whether it is technology or trade that has been responsible for the increased disparities between rich and poor within those economies.

Just how much disparity are we talking about? Between 1973 and 2005 across US male workers aged 35–44 average annual wage income rose from US\$49,705 to US\$54,525 (in constant, inflation-adjusted, 2005 US\$). The median such worker, however, saw his annual wage income decline from US\$45,785 to US\$40,964. Thus, in this reading, over 30 years of economic growth and globalisation brought no benefits to those relatively poor but instead saw only increased disparity between rich and poor.

If similar figures and trends manifest across developed countries other than the US, then the inequality side of the globalisation debate has a well-defined set of parameters to it where reasonable observers might well have to agree to disagree. But extend this comparison to a global scale, and the picture changes. Between 1981 and 2005 China brought 627 million people out of extreme \$1/day poverty, even as inequality there rose from a Gini index of 0.28 to 0.50. That experience shows that a period of intensifying globalisation can, for initially poor countries, improve the lot of the very poorest in society even as measured inequality rises from just macroeconomic growth, i.e., the increase in average incomes.

More important, however, this throws into sharp contrast the gains of the poor in the world against the losses of those already rich. If globalisation increases disparities between rich and poor within any one country, that increase is nonetheless likely completely overwhelmed by globalisation's reduction of the income gap between rich and poor nations. And, in the case of a country like China or India or myriad others, the increase in overall national income from the trade impact of globalisation probably swamps all else.

2. FINANCIAL AND ECONOMIC INSTABILITY

In the midst of perhaps the world's most serious financial and economic crisis since the Great Depression, it can be difficult to maintain distance and remember the good things that financial liberalization and globalisation can engender. Financial markets continue to be the single most widely-used way historically available to channel resources from savers to investors, to facilitate innovation and economic growth that in turn has raised the income of humanity 50-fold in the last 200 years.

Up until the current global financial crisis the previous two—Mexico 1993; East Asia 1997—began in emerging economies, with their running up massive current account deficits, taking on debt denominated in foreign currency, and with large inflows of short-run portfolio investments by foreign commercial banks. In the current crisis, by contrast, it is the United States that had its current account deficit ramp up from essentially zero in 1990 to over 8% of GDP by 2006—a sum greater than the entire GDP of India. In the two previous recent instances, large sudden reversals of short-run capital flows sparked the crises. In the current situation, what brought about the collapse was the default of subprime mortgage accounts in the US, which although initially only a small portion of overall bank portfolios, had nonetheless grown pervasive, multiplied up into the global financial system through massive leverage.

In all cases, however, it is the excesses of the banking sector that first created the conditions for crisis and then later unwound to bring about collapse. National financial crises can occur even without the intrusion of globalisation. Unquestionably, however, cross-country financial contagion and trade

spillover aggregate demand impacts can potentially spread such crises across borders, and it is a subtle calculation to determine the costs and benefits here.

3. CLIMATE AND ENVIRONMENTAL CHANGE

Global climate change from economic activity—the burning of fossil fuels—is now as near to scientific fact as almost anything can be in the study of economics. Its connection to globalisation is not perhaps as direct as, say, the cross-country spread of financial crises. On the other hand, its impact on human welfare is likely several orders of magnitude more pronounced and enduring. At the same time the international tensions that arise, and any useful policy proposals for ameliorating its effects are necessarily global and bring to bear all the same issues in every debate on globalisation. There is room here to put the matter only in the starkest simplest terms. The accumulation of greenhouse gas emission in the world's atmosphere has, historically, been due primarily to those countries now already developed. The greatest increments to that accumulation, however, are presently due to those countries such as China that are rapidly developing and raising their income levels. Schemes to stabilize greenhouse gas concentration in the atmosphere to prevent further dangerous disruption of the world's climate will succeed only with an agreement that allows both developed and emerging economies to arrive at a cooperate solution.

With globalisation both a driver of rapid growth in emerging economies and a mechanism for ever greater interaction and dialogue across different parts of the world, globalisation and global climate change will have their future progress intricately connected.

CONCLUSION

This article has outlined in the briefest terms one view on the current state of globalisation in the world economy. It points to three large issues, surrounding which most policy concerns can be seen to derive. The three are global inequality; global financial and economic stability; and global climate change. The quantification of costs and benefits on these three dimensions, and subsequent informed policy debate will usefully and significantly drive forwards our understanding of globalisation.

