

Finance, failure and

Complex global processes connect the fate of communities across the world. Yet the problem solving capacity of the existing system of global institutions is ineffective, unaccountable and slow – as the financial crisis has illustrated. **David Held** and **Kevin Young** offer some pointers.

‘Despite minor reforms, the IMF remains locked into a system that encourages strong US dominance of the institution’

At its core the recent failure of the global financial system reflects profound faults in our system of global governance. There has been no clear division of labour among the myriad of international institutions that have sought to address the crisis: their functions have often overlapped, their mandates have conflicted and their objectives have too often blurred. Attempts to tackle the crisis have been dogged by competition between states – leading to a dissonant response.

Equally damaging, the existing system of global governance suffers from severe deficits of accountability and inclusion, particularly in relation to how less economically powerful states, and hence their entire populations, are marginalised or excluded from decision making. This distortion is reflected in the impact of the financial crisis. While those in the rich developed world are bombarded daily with news of the breadth and depth of the economic slowdown, less prominent in the headlines are the effects of the crisis on the most vulnerable populations of the world. The World Bank has recently estimated that as many as 90 million people will be trapped in extreme poverty in 2009 as the result of the global financial crisis, and the number of chronically hungry people is expected to climb to over one billion.

As the existing system has proved largely inadequate to predict, moderate, or contain financial

instability, the need to better balance the two worlds of financial globalisation – private financial activity on the one hand, and public financial governance on the other – has become increasingly apparent. The globalisation 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.

The existing system of global financial governance has, to be sure, 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 (IMF), the Bank for International Settlements 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 Organisation of Securities and Exchange Commissions, and the Financial Stability Forum. Together these institutions have in some respects imposed limits on 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 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 between them. Further, fragmentation and competition between states has led to global challenges being addressed in partial and even erratic ways.

Even when systemic problems have been identified, proportionate action has not been taken. For example, in 2007 the Bank for International Settlements recognised several structural problems with the international financial system, but this recognition remained at the level of research and observation, rather than action. In March



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2008, the Rome meeting of the Financial Stability Forum and its subsequent recommendations delivered to the G7 finance ministers and Central Bank governors the following month identified a number of key weaknesses underlying the financial system, and recommended provisions for some substantive reforms. The Forum 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, it took the urgency of a deepening crisis to have the recommendations command real attention and debate.

Compounding these deficiencies has been the fact that historically most institutions of financial governance have adopted an exclusionary model to participation. Despite some recent minor reforms to its voting rules, the IMF has remained 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 often been unable to secure sufficient sources of funding to widen its capacity and scope.

The 2008 G20 summit in Washington DC saw an unprecedented attempt to engage in participatory reform by admitting countries such as China and India into the Financial Stability Forum. More recently, the Forum has expanded even more and has been renamed the Financial Stability Board. Traditional outsiders like developing countries had to fight and advocate for such changes, and they will have to do more. The Basel Committee on Banking Supervision has also been expanded, to include countries such as Australia, India, China, Brazil, South Korea and Russia. As the institution which designs the *de facto* banking regulatory standards for the world, its composition was beginning to look increasingly arbitrary, with many countries without any formal representation in the Basel Committee having a higher concentration of capital in their banking systems than those within the Committee (see bar chart). These recent changes to the Financial Stability Forum and to the Basel Committee show that focused, critical public attention can lead to progressive reform of global governance institutions. Yet broader questions of governance remain, such as the transparency of decision making and fuller participation of stakeholders.

If reform of the global financial architecture is ambitious enough to be truly effective, it will ultimately be a highly politicised process. At the recent London G20 summit, progress was made, but the detail of many significant changes is yet to be worked through. Whether it will be remains to be seen. One of the greatest achievements has been to focus public attention and to encourage thoughtful debate on financial

governance, and in the time ahead many further 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 globalisation. 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. 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.

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.

When the costs of financial crisis are distributed so widely, what incentive does an 'in group' of governing institutions have to reform its practices?

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 globalisation 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 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 centralised coordination and authority, especially once financial markets experience a resurgence, and with it a re-strengthening of private financial power. ■



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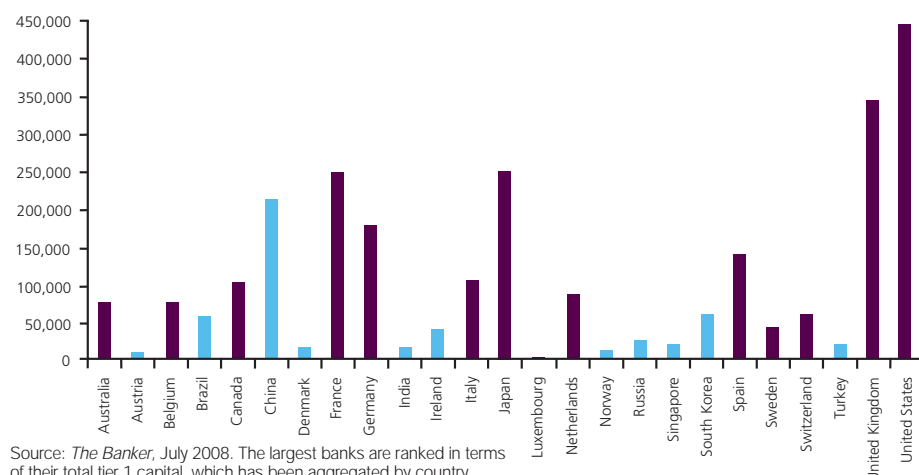
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Country composition of the 100 largest banks in the world

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