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Global Financial Architecture, Legitimacy, and Representation: Voice for Emerging Markets

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Introduction: the problem

The absence of a major financial crisis over the last 2-3 years has meant that global financial architecture (GFA) as a policy issue has been less prominent in the news. Yet little has changed in terms of the underlying conditions which led to earlier outbreaks of crisis and, in this sense, the risk remains high. Policy is based on the economic theory that efficient market allocation of capital is beneficial for developing countries, corrected by the idea that the system must be underpinned by functioning institutions of governance and sound macroeconomic policies. Contemporary GFA thus still focuses on facilitating the free flow of capital across borders, preserving the same market-based characteristics which emerged in the 1980s and 1990s that were common to the rapid succession of crises from 1994 into the new millennium. Official policy has failed to ask whether net capital flows in such a system are stable and positive for a diverse group of developing economies. In other words, is there evidence to support the theory, and if not should we change the theory or try to change the facts? IFIs, in particular the IMF, have continued to focus on this policy mix despite the pressure it puts on domestic political systems, including social expenditure (Nooruddin and Simmons 2006), especially where the democratic preferences of electorates directly confront the preferences of international investors and, eventually, conditionality. This was etched in the drama of the Argentinean debt workout.

Meanwhile, the post-crisis period obscures some developments which are nothing short of alarming for the future of global multilateral financial governance. The major Asian and Latin American debtors of the IMF have all but paid off their loans and many are on their way to building an impregnable reserve fortress against future crises, and they question a range of IFI policies. A series of electoral outcomes in Latin America indicate considerable dissatisfaction with ongoing global economic integration and the policies promulgated to deal with it. Debtors are turning to regional development banks where developing country influence over policy is greater. National or regional solutions to future crises are the clear preference, avoiding what was seen as intrusive and inappropriate IMF and other IFI policy advice and conditionality.

These countries are effectively 'checking out' of the Hotel Capital Mobility built by the global financial architects

While they do want capital inflows, they are determined never again to submit to the humiliation and intrusion of the conditionality of the Bretton Woods institutions (BWIs). The Fund's programmes are now limited to a chronically-indebted sub-Saharan African clientele, where there is little evidence that forty-plus years of IMF policies have been particularly favourable for development growth prospects either (Vreeland 2003). Nor is the rapid growth of international capital flows associated with the GFA closely correlated to economic growth in non-industrial countries, as the chief economist of the IMF among others recently concluded (Prasad, Rajan, and Subramanian 2006). This seismic shift bodes ill for international co-operation and tells us that the current financial architecture lacks both effectiveness and political legitimacy in a wide range of countries, and that effectiveness and legitimacy are linked.

This policy brief analyses what this emerging situation means for effective global financial governance, and what can be done about it. The focus is largely the BWIs, and the IMF in particular, as the lynchpins of the GFA.

The Analysis

'Financial architecture' may be understood as the sum of international institutions and co-operative processes aimed at managing global imbalances, exchange rates, transnational capital flows, and financial market stability, from crisis prevention to management to debt workout. This involves policies at both the domestic and international levels, and most importantly the relationship between the two. The current period of relative calm provides a respite in which serious reflection should take place, not least because past periods of calm have induced complacency followed by surprise at the next crisis. Furthermore, the recent September 2006 vote by the IMF Board of Governors to increase voting rights for China, Korea, Mexico, and Turkey, plus the preparation of more far-reaching IMF reforms by 2008, make it urgent to reflect on both the objectives and the structures of GFA. This policy brief argues that the proposed reform agenda is still far from complete.

Have the reforms worked so far? The reform of the international financial architecture has so far emphasised the adaptation of crisis-prone economies to the imperatives of a market-based system. The theory is that cross-border market allocation processes yield the most efficient results, optimal for developed and developing countries alike. In the face of potential market failures linked to information deficits and uncertainty, sound policies and good governance provide necessary collective goods for these optimal outcomes. On this basis, a range of macroeconomic policy and corporate behaviour codes and standards have been promulgated and are monitored (ROSCs, FSAPs, systemic monitoring of financial stability through the Financial Stability Forum; financial supervisory standards from the Basle Committee on Banking Supervision, corporate governance standards, etc.). In a crisis, severe and increasingly complex prescriptive conditions reaching into the micro domain have been placed on emergency adjustment finance loans and/or debt workout, as well as on longer run development lending. The requirements of this conditionality are often in severe tension with long-run domestic political and development imperatives (Vreeland 2003) such as economic growth, social and distributional justice, educational and health policies (Nooruddin and Simmons 2006).

The original aim of the BWIs as central pillars of the international financial architecture was to institutionalise co-operation so as to ease the tension between domestic (democratic) preferences and the requirements of international monetary and financial stability. This goal is no longer effectively accomplished and *if* stability is the outcome, it comes increasingly at the expense of domestic policy autonomy and preferences. A better match between national political imperatives and the requirements of GFA is clearly required, particularly if democratic preferences are to be meaningful in poor countries.

While strengthening governance and implementing sound national macroeconomic policies is a positive step, this does not address the problem of financial and monetary instability in emerging markets. Many crisis victims had debt to GDP ratios, inflation records, or current account balances which were entirely honourable relative to the performance of developed countries. *Something else is going on*, and one aspect of this has been referred to by Eichengreen and Hausmann as 'Original Sin' (2005, 266: "the inability of emerging markets to borrow abroad in their own currency"). They show there is little evidence that developing country crises are due to weak institutions or the lack of credibility of their fiscal and monetary policies. Those forced to borrow in foreign (hard) currencies face debt service volatility *five times higher* than developed economies (266). While the quality of governance and the credibility of policy varied greatly across developing countries, original sin was an almost universal feature (245), suggesting a very weak correlation between institutional/policy reform and crisis prevention.

The systemic architecture needs to accommodate these and other inherent difficulties of developing economies, given that these economies are most of the world's population. It is also equally clear that under the current architecture, *despite* the implementation of institutional and policy reforms, net private capital flows reach the developing world irregularly at best (World Bank 2006, 180-7; Prasad, Rajan, and Subramanian 2006) while total external debt loads remain high (World Bank 2006, 193-9, 201-3). Where net capital flows are positive, they are unevenly distributed to a few major emerging markets which often have very weak institutions of governance and policies which are far from market-friendly (especially China, which receives the most by far).

Policy is based more on economic theory than on the facts of the matter, and policy therefore needs to be better grounded in the real world.

Political underpinnings: who decides? The approach to financial architecture and its reform is in large measure problematic from the point of view of developing economies. More radical reforms such as the IMFs proposed Sovereign Debt Workout Mechanism (SDRM) were defeated by an alliance of developed country private sector interests and the United States. The system is insufficiently

flexible to cater to economies at their respective levels of development, permitting national authorities sufficient room to manoeuvre as they seek to balance their international obligations with the political and social pressures of the development process at home. *Reform requires directly confronting the political underpinnings and distributional impact of the financial architecture, especially with respect to a) who decides, in whose interest?; b) the legitimacy of both decision-making processes and the policies which result; and c) the links between the decision-making process and outcome.*

Case research reveals a familiar pattern (Baker 2005; Cohen 2003a, 2003b; Claessens and Underhill 2006). Financial policy-making typically takes place in relatively closed policy communities in which central banks, finance ministries, regulatory agencies, and their private sector interlocutors consistently interact to determine the scope of the market, the terms of competition, and the costs of supervision and regulation. While the decisions taken may affect a broad range of interests in society, the preferences which underpin policy outcomes are the product of a close alliance of private actors and autonomous state agencies, and accountability is limited. Enhancing the independence of central banks has most likely contributed to the situation. The public choice literature warns us that such arrangements run a persistent risk of policy capture.

Cross-border market integration has exacerbated the problem. The growing technical complexity of global markets has rendered public agencies dependent on the preferences of private agents and has contributed to the emergence of closed and *transnational* policy decision-making clubs. International level decision-making is yet further removed from traditional lines of democratic accountability. Decisions at the international level have become dominated by these policy communities rooted in but increasingly detached from the G-10 developed countries, manifested in the strong public policy preference for a market-oriented financial architecture. The policies of developed countries have thus tended to facilitate further cross-border integration accompanied by 'governance light' with little of the legal and regulatory framework normally associated with functioning domestic financial markets.

The punch line is that private actors, in particular large internationally-active financial institutions, have far more influence on financial architecture reform decision-making than developing country members of the BWIs. Those most successful in influencing decisions obviously derive the most benefit from them. Despite their pervasive influence on global supervisory and other standards, institutions such as the Basle Committee on Banking Supervision and the Financial Stability Forum (FSF) either exclude non- G-10 countries altogether or include a few 'reliable' outsiders (Australia, Singapore, and Hong Kong in the FSF), yet they regularly interact with private financial institutions. The rules of the game are clearly still made by developed countries and their major financial institutions, which benefit considerably and have learned to cope with the uncertainties of cross-border financial integration. Yet the functioning of the international financial architecture imposes serious costs on developed economies (Bhagwati 1998; Claessens and Underhill 2006), the poorest citizens of which often bear brunt of adjustment in case of debt or financial crisis, and this conflicts directly with the widely-trailed goal of poverty alleviation and the reduction of inequality (Wade 2004).

Political underpinnings: legitimacy and representation Cross-border financial integration results in a considerable tension between what national policy makers are *required* to do in a democratic context and what they actually *can* do in the face of global financial constraints. Aggravated in the case of developing countries, this inefficiency of domestic policy-making shakes public confidence in national government, and leads negatively affected segments of the public to challenge the process of cross-border integration (globalization) itself. If international outcomes consistently enhance the problem, the institutions most associated with enforcing these outcomes at the global level, such as the IMF and financial architecture, will also be challenged. Yet 'going it alone', abandoning interdependence and the global economy, is very costly for skills- and capital-scarce developing economies, and creates serious costs for others in the GFA. Competing stand-alone policies exacerbate collective action problems *and* the inefficiency of national strategies.

The paradox is therefore that enhanced global governance is part of the solution. It involves pooling competences to resolve the dilemmas of national policy making born of cross-border market integration, also resolving collective action problems among agents at the international level, thus reducing the costs of both policy and market interdependence. However, co-operation will founder if policy does not attend to the issue of norms and legitimacy. If the institutions of global financial governance fail to improve outcomes, collective goods provision will collapse in favour of competing national solutions which, as the 1930s demonstrated, are not very good for anyone.

What is to be done? What is legitimacy in this context?

The first point is that the problem of underlying norms and legitimacy needs to be addressed explicitly in the reform debate. Limiting reform to narrow technical issues facilitates the policy preferences of those most at home with such an agenda, excluding other interests and precluding more legitimate outcomes. The second point is that the question of legitimacy needs to be analysed in direct relation to the GFA policy process.

Legitimacy is an elusive concept; it is seldom clear when it is present and in what proportion, yet ever so clear when it is not. The starting point from Max Weber is that legitimacy is the *perception* of legitimacy, and is enhanced when the authority of political elites is accepted by the ruled, not merely based on coercion. Power relationships, rules, and outcomes must conform more or less to the shared norms and values of the political community, implying notions of justice or truth above and beyond crude patterns of self-interest. Dominant and vested interests must therefore be willing to take losses from time to time. Without a modicum of legitimacy, effective governance is greatly impaired and relies on raw, often coercive power relationships.

The literature also distinguishes between two elements integral to achieving political legitimacy: the *input* or process side versus the *output* or policy outcome side (Scharpf 1999). The relationship between the two sides of the equation is an important but uneasy one. Consistently sound policy (legitimate output) might reduce the need for an acceptable process (input legitimacy), enhancing authoritarian regimes. A sound democratic process might be undermined by producing consistently bad policy outcomes, destabilising the regime. In any event, legitimacy may be based on either or both of the following two factors. First, *specific* support (Easton 1965, 265) relates to support based on acceptable policy outcomes in the short term, and may compensate for a lack of input legitimacy or the lack of a coherent political community. Secondly, consistently legitimate processes and/or acceptable outcomes eventually confer on well-established political communities a reservoir of legitimacy or diffuse support over time (Easton 1965, 273). Where diffuse support is present, even if authorities produce bad outcomes for some time, the reservoir will underpin the broad legitimacy of the regime as such, and specific support will prove less important.

If the emergence of governance across the domestic-regional-international divide is in fact part of the solution, this multi-level governance *does* complicate matters in terms of legitimacy. National authorities in functioning political systems may generally count on a considerable reservoir of diffuse support, but this is not the case for global level institutions. At the international level, the sense of community and belonging is weak, the lines of accountability distant, and underlying shared norms likely to be poorly developed.

This leads to two crucial arguments:

1. Generating *specific* support will be of prime importance for emerging patterns of global governance: this means that global financial governance needs to get the policies consistently right for enough of the people enough of the time!
2. Over time, *a more legitimate and inclusive process on the input side is likely to enhance the likelihood of better policies, and therefore more acceptable outcomes, on the output side*, in addition to enhancing the sense of political community and the emergence of a modicum of shared norms and values.

In other words, a lot can and must be done in the short term by achieving better policies, but that is not the end of the story. *As we think about legitimacy in global financial governance, we therefore need to think about **who** is included in the process, how a broad underlying consensus might be built, and thereby how to enhance the legitimacy of the outcome through sound policies appropriate to a wider range of interests, eventually building longer-term diffuse support for global financial governance.* Even sound standards and policies will be unsuccessful if they are perceived as imposed by an unfair process.

Principles and forms of representation - enhancing the input side Representation of the diversity of interests affected by patterns of multi-level financial governance now comes into focus. Specifically, policy-makers need to explore how forms of representation might best be employed to enhance the *input* legitimacy of global financial governance, increasing the likelihood of a more legitimate output side, in the longer-term forging shared norms and enhancing the sense of political community in a multi-level setting. At the same time, the level of expertise in the policy process must not be diluted. No easy task.

Better representational patterns imply better linkages to democratic and other systems of accountability. A variety of principles and forms of representation may be identified, sometimes conflicting with and sometimes complementing each other. The most obvious principle is 'one person-one vote' (unwieldy in a global context), or 'one member (state)-one vote'. But members of GFA institutions may be of differing economic and political importance, leading to the principle of representing members differentially according to e.g. *wealth* and/or *population*. That some members contribute more resources to institutions than others, voluntarily or according to the rules, gives rise to the idea of a 'shareholder principle' of representation related to the 'property' or proportional stake held by a participant. This principle may conflict with both the 'one member-one vote' and the 'population size' principle. Another principle is the representation of those whose common interests derive from the fact they are most affected by decisions, such as the users of services (e.g. by monopoly providers), in the BWIs case, this means the debtors (*who really* pays the highest price in adjustment?). A derivation of this in some contexts is 'corporatist' representation, wherein social partners are represented *vis à vis* other competing constituencies.

Finally one may invoke the principle of minority representation to prevent possible 'tyranny of the majority'. The purpose is to strengthen representation of the numerically or otherwise weak and to grant them a formal role in decision-making. Processes which systematically exclude may be legitimate to a broad majority of the community, but can be prone to serious breakdown if coherent minorities rebel.

The most important point is that legitimate systems of governance at the domestic or international level employ a *mix* of these principles depending on the context. Yet if one observes the current BWIs, *only the shareholder principle is meaningfully employed in practice*. Even that is not applied properly, given the dramatic changes in the relative size of member country economies. The IMF 'basic vote' system reflects the 'one member-one vote' principle, but the basic votes of members have dwindled to effective insignificance. In other institutions with a global impact such as the Basle Committee, one member-one vote representation is even more exclusionary because membership is so limited. Such patterns of governance are reminiscent of apartheid or class systems wherein only particular types of people qualify as 'citizens' with a vote.

Different forms of representation represent different sorts of interests better than others, and the needs and preferences of groups of members may vary, leading to conflicting policy norms. Some may value stability, others risk; some may value long-run growth and development, or distributional justice. Representational systems employing mixed principles help to forge consensus among competing preferences. One point is clear: if outcomes consistently prove unacceptable to a broad range of interests engaged in multi-level patterns of governance, then the regional or global level institutions will be quickly depleted of any accumulated legitimacy and fatally weakened. Local or national level communities will assert their claims more vigorously, leading to a decentralisation of governance which further undermines the capacity of national instances to cope. This is likely to increase the level of conflict at the international level. Better outcomes will prove closely linked to a better process, which is why most democracies govern better.

Conclusion

Functioning global financial architecture is needed to resolve policy dilemmas at the national level born of cross-border financial market integration, even if these dilemmas were fostered by states in the first place. However, a range of emerging market economies are checking out of the Hotel Capital Mobility, revealing an urgent need to attend to the political and normative underpinnings of the system. The stakes are high, and global collective goods provision is more efficient than, for example, self-insurance through large foreign exchange reserves: as Summers, Rodrik, Rogoff, Obstfeld, and others have recently argued in a range of forums, the cost of Asian reserves to their national economies is somewhere between 1-2% of real GDP, at the least comparable to the expected gains from a successful Doha Round (see e.g. Summers 2006).

Current global financial governance is deficient on both the input and the output sides of the equation. It reflects a narrow range of preferences and operates on the basis of the self-interest of the largest shareholders and their private constituencies, who make the rules in their own image. Better policies are certainly needed, and these are rendered more likely through better patterns of representation in the institutions of global financial governance, based on a broad mix of representational principles. More acceptable outcomes preserving the benefits of interdependence while reducing the worst of the costs will enhance development prospects, especially for poorer societies. Better development prospects mean more growth and enhance the possibility of more social justice for all.

Policy Recommendations

It is duly recognized that some of these proposals overlap with those proposed elsewhere; the list is not exhaustive but reflects and indeed goes beyond the analysis of this policy brief. The aim is to emphasise the link between the need for a better process and the immediate need for better policy.

1 Concerning the shareholder principle specifically

- 1.1 correct the distortions of the shareholder principle as proposed in September 2006, and develop a new formula for automatic 5-year recalculation of votes to account for changing relative size of economies
- 1.2 the US must think seriously about an eventual end to its effective veto over amendments to the Articles; this should be traded off against a combined if substantially reduced EU vote where neither would claim a veto
- 1.3 the selection process for top jobs in particular at the BWIs needs to be taken out of the hands of the US and the EU members, and conducted in a transparent manner on the basis of merit

2 Apply a mix of representational principles to the (Executive) Boards of the BW institutions and other IFIs

- 2.1 increase basic votes to minimally 10% of the total and commit to maintaining that proportion over time to enhance the one-member one vote aspect of representation
- 2.2 add the 'population principle' to the calculation of votes to enhance the representation of citizens
- 2.3 institute the formal representation of social partners at annual meetings and in setting the broad outlines of policy in a range of issues
- 2.4 the influence of the largest creditors should be balanced by the influence of the largest and other debtors: add enhanced but temporary representation for debtors as 'users' so that those who bear many of the risks and costs of adjustment have more influence over policy (but *not* over the specifics of their own loan packages)
- 2.5 give a deliberate boost to the representation and votes of the poorest and weakest economies over and above increases in basic vote or the population principle referred to above
- 2.6 some mix of these principles should be extended to other standard-setting bodies involved in global financial governance

3 Improving the policy output side

- 3.1 recognize the importance of domestic social and political imperatives by enhancing the 'room to move' for national governments e.g. promoting judicious use of controls on short-term capital flows
- 3.2 openly acknowledge the one-size-fits-all problem
- 3.3 calibrate lending conditionality to the level of economic development, and ensure that applied conditionality conforms to the goal of poverty alleviation
- 3.4 promote domestic development policies which have been successful historically, including degrees of domestic financial repression
- 3.5 facilitate adaptation of international standards to diverse national contexts and institutional/legal traditions
- 3.6 ensure sensitivity to regional conditions and organise regional policy forums

4 Take effective measures against the potential for policy capture

- 4.1 strong public oversight and enhanced accountability and transparency in the policy process with to deal with the potential for capture
- 4.2 BW and other institutions must be sufficiently autonomous from major creditor countries to fulfil their mandate free of direct interference from powerful states and their private sectors
- 4.3 policies must also apply to members equally, not just to those too weak to resist

5 Debt workout

- 5.1 the failure of the SDRM has certainly not eliminated the need for more clarity in debt workout situations, including the issues of a payment stop and burden sharing
- 5.2 bondholders, treasuries, and the GFA are not the only parties, and the costs born by the poor and poor economies in debt workout situations needs explicit recognition
- 5.3 further debt relief for the poorest economies, with enhanced incentives for more aid versus loans for an appropriate policy mix for poverty alleviation, human capital development, and health and welfare provision

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