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Abstract

Despite regular and serious systemic volatility, reform of international financial architecture remains limited, retaining market-oriented characteristics and adjustment mechanisms. A failure of the architecture to focus on the political underpinnings of global financial and monetary governance yields crucial deficiencies. The article defends three propositions implying a serious challenge to political legitimacy in contemporary financial governance: i) external financial constraints conflict with a range of potential domestic, particularly democratic, political imperatives; ii) developed state initiated global financial integration strengthens private interests in the policy process, narrowing the definition of the public interest in a democratic context; iii) market-friendly institutional reforms put pressure on domestic socio-political arrangements underpinning longer run political legitimacy. The article first analyses norms and legitimacy in global financial governance; then outlines the constraints on public policy of global financial market integration in the light of the foregoing analysis of legitimacy; thirdly it discusses possible solutions.

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Introduction

Over the past two decades, from the 1980s debt crisis to currency and financial crises of 1997-2002, the global economy has experienced regular episodes of monetary and financial instability. The fallout manifested itself in monetary disruptions and capital flight to developed economies, repressed investment activities and considerable loss of GDP. Unemployment often rose to unprecedented heights and the income of a wide range of social groups declined sharply, leading to social instability and political unrest. This raised financial crises and the socio-political costs associated with them to the top of the policy agenda in international organisations and national governments. There was a considerable period following the outbreak of the Peso and Asian Crises when more or less radical reforms of global financial architecture were urgently discussed.

Although taming capital flows and maintaining systemic stability now ranks as one of the priorities of global economic governance, both debate and reform focused largely on technical deficiencies (Eichengreen 1999; Goldstein 2001). The current architecture governing global financial and monetary relations—institutions, structures and policies—was crafted by the US Treasury, the G-7 and the International Monetary Fund (IMF); the limited nature of the reforms reflects the preferences of an alliance of the official national and multilateral agencies of financial and monetary governance with powerful transnational market players based in these highly developed economies, which have so far

avoided the consequences of financial and monetary instability experienced by developing economies. The reformed system centres on facilitating and clarifying market signals through policy transparency, institutional reforms/good governance, flexible exchange rate management, private-sector involvement in crisis resolution, and debt restructuring.¹ A recent discussion concerning the distribution of quota and voting in the International Financial Institutions (IFIs) has opened (IMF 2006a, 2006b), which may yield results in September 2006.

The current period of calm provides an appropriate moment for reflection on the nature of contemporary financial governance and its potential weaknesses.² This article argues that the largely apolitical and positive nature of reform has served to obfuscate crucial dimensions of policy that underlie the modesty of efforts to improve the governance of global financial and monetary relations. Technical adjustments in regulatory standards, debt restructuring schemes and exchange rate regimes are contingent upon domestic and international configurations of interests and power. Architectural reform is not only about policy-making and regulatory or economic efficacy but, in the final analysis, about the enhancement of social and economic conditions and is about financial stability for whom and for what.

The limitations of reform lie in a general failure to address the political and normative underpinnings of global financial governance, about which both academic and particularly policy-making circles have been too silent.³ This corresponds to a failure to address the emerging legitimacy deficit of financial governance, as a number of states and regions have begun to “check-out” of ‘capital mobility hotel’ constituted by the IFIs, choosing regional or domestic

solutions to the problem. Asian countries have paid off their IMF debts and built up massive reserves, leaving themselves free of IFI conditionality in future crises. The electorates of a range of Latin America countries have signalled their ongoing frustration with norms of global economic governance and the results it apparently achieves, and financial instability has played an important role in these developments. This leaves a rump of poor, mainly African countries dependent on the system, submitting to policies they played little part in designing. The multilateral financial architecture as a mechanism of governance is under severe threat. The risk is that as financial crises fade in our memory, complacency has become a palliative for the genuine loss of direction in the further reform of the global financial regime.

The principal claim is that enhanced effectiveness and legitimacy of the reforms lies in the explicit consideration and incorporation in the reform process of the political and normative prerequisites that are an integral but seldom discussed part of global financial architecture. This article therefore analyses the underlying dimensions that sustain the international financial order in relation to three different but interrelated propositions. First, the tension between what national policy makers are required to do in a democratic context and what they can actually do in the face of global financial constraints has shaken public confidence, perhaps in the democratic form of governance itself. Second, financial globalisation has strengthened the position of private actors, rendered regulators and supervisors more dependent on private market interests and contributed to the emergence of closed policy networks. These changes, most often encouraged by states themselves (Helleiner 1994; Underhill 1997), have

increasingly aligned financial policy and regulatory processes to the preferences of powerful market players, crucially altering the notion of the public interest in relation to the financial domain and posing a fundamental problem of exclusion and democratic accountability. Third, institutional reforms along market-friendly lines, propelled by the transnationalisation of financial markets, have threatened to destabilise the complex socio-political arrangements that underpin the contrasting forms of capitalist development and to undermine the established basis of democratic credibility associated with these forms. All three propositions imply a serious legitimacy deficit in the mode and content of governance.

These propositions are developed in three steps. First, the article will analyse the literature on legitimacy and norms as applied to the national and global levels of governance, defining what is meant by legitimacy in this context and how it might be conceptualised across levels of governance. Using the standard distinction of the input versus the output side, the piece will argue that while an outcome perceived as broadly legitimate is the ultimate test, a better policy process on the input side is more likely to lead to such an outcome, including a reassessment of the underlying policy norms themselves. Thus the article acknowledges that global-level governance can contribute to resolving some of the dilemmas which confront national governance, though this is contingent on explicit recognition that the reform of the emerging multi-level system of global financial governance presents policy problems in terms of norms and legitimacy. In the second section, an analysis is provided of the current dilemmas that the international financial system poses to public policy, in particular at the national

level, assessing the often polarised literature as subtly and fairly as possible. In light of the discussion in section one, the article goes on to demonstrate that these dilemmas are a problem for the legitimacy of the financial governance at national and global levels, dilemmas not successfully addressed by the official consensus on the current financial architecture. The policies advanced under the current architecture have strong but implicit underlying norms which need direct acknowledgement. If the issue of legitimacy and these underlying norms is directly considered in the reform debate, then the question of inclusion and representation in the policy process, as well as the content and implementation of policies, will come under closer scrutiny. Answers need to be found to questions as yet unaddressed by the reforms: what is the relationship between national development aspirations and the obligations of international adjustment processes? For whom and for what is financial governance to be reformed, and with what sort of distributional impact? The third section advances a range of political and normative prerequisites for successful reform of global financial governance. The conclusion will summarise the claims and arguments and will take up the three propositions once again in light of the analysis.

I. Norms and Legitimacy in Global Governance

The frequency and severity of financial crises have both reinforced the argument that the global economy is poorly governed (Held and McGrew 2000; Murphy 2000) and deepened the need for understanding the nature of global-level governance. While scholars have not reached a consensus on the connotation of global governance, they have all concurred that the term refers to the manner in

which rules are made and power is exercised, without centralised authority, in the management of strategic interactions among various entities for realising collective goals. This definition has a conceptual emphasis on the importance of steering the various multi-level entities towards shared rules and an empirical understanding that those subject to the process of global governance accept these rules as authoritative (Finkelstein 1995; Keohane 2002; Rosenau 1995). What underpins this notion of global governance is a normative implication that governance without government should be based on legitimate rules and that rules are only legitimate if they conform to widely acceptable values and norms (Bernstein 2004; Keohane 2002).

Legitimacy is an elusive concept in the best of circumstances. A rough definition illustrates the point: political legitimacy consists in satisfying enough of the people enough of the time. It is difficult to establish with precision when a policy or regime is legitimate, for how many of those affected, and therefore if legitimacy is present. Yet if and when it fails to materialise or vanishes, political problems and potential breakdown soon follow.⁴ A more formal definition demonstrates similar difficulties: legitimacy is "...a property of a rule or rulemaking institution which itself exerts a pull towards compliance on those addressed normatively because those addressed believe that the rule or institution has come into being and operates in accordance with generally accepted principles of right process (Franck 1990: 24)." As Weber clearly established, it has to do with the vagaries of perception in a collective setting: "legitimacy is the perception of legitimacy" (Mather 1999, 277), and Weber goes onto explore conditions under which legitimacy might be established as a result of legal,

traditional, or charismatic authority (Weber 1978, 215 check source if p. no. correct). A useful discussion by Bernstein establishes that in this sense, legitimacy is concerned with the social construction of intersubjective beliefs in a defined community, and that at least insofar as forms of (democratic) accountability of rulers to ruled prevail, legitimacy will be rooted in accepted norms of social justice and truth (Bernstein 2004, 14-16; see also Steffek 2000). It should be noted that the notion of a defined community is inherently problematic in terms of the multiple and overlapping layers of global financial governance, a point which will be taken up later in the discussion.

This leads to a further distinction in the literature, that between the use of power to achieve compliance, and authority, which involves some degree of consent and thus legitimacy (Lindblom 1977, 17-32). Power leading to acquiescence in particular regimes or policies does not constitute legitimacy unless the norms and the policies in which they manifest themselves are perceived by the community as *authoritative*, and that they can be justified in terms of shared beliefs (Beetham 1991, 11). Power relationships are therefore strongest when they are based on shared, therefore legitimate, norms and beliefs based on defensible notions of justice in a collective context. These norms may well be self-interested, reinforcing their authoritative nature, though legitimacy is more genuinely present when outcomes are accepted despite being in conflict with the self interest of individuals or groups, perhaps a substantial segment of the community.

Legitimacy, then, confers on individuals and institutions the authority to make rules and exercise power within a given domain of activity, and is crucial

to effective national or global level governance. Motivating states and other entities to accept and follow domestic or international rules through the legitimate exercise of authority is likely to be a superior alternative to other mechanisms such as coercion and self-interest. Legitimacy contributes to the acceptance of shared rules and thus governance processes by providing political communities with moral incentives or 'internal reasons' for compliance. When states and their citizens believe that rules are legitimate, they are motivated to comply with these rules by an internal sense of obligation rather than by the fear of retribution or by a calculation of self interests which are more costly and whose effects tend to be ephemeral (Hurd 1999).

These notions of political legitimacy are of course most often discussed in direct relation to national states, where the notion of political community and shared beliefs is usually well-established. Here, use may be made of David Easton's (1965) extensive account of legitimacy, where he distinguishes three interrelated aspects of the problem: political community, regime, and authorities (Easton 1965, 165). A given political community may be perceived as legitimate, and in turn may distinguish between the legitimacy of the regime broadly defined, versus the legitimacy of its particular (temporary) occupants, the authorities. Support for these three elements of political legitimacy can be further divided into a) *specific* support, by which he means performance satisfaction in the short term (p. 265), wherein the system will fail some or all constituents some or all of the time, and b) *diffuse* support (p. 273), which is not dependent on short-term performance and is underpinned by an emergence of common interests and mutual accommodation constitutes a sort of long-run

reserve on which the political legitimacy of authorities and regimes may be based and draw. The point here is that over time a viable political community may emerge wherein the legitimacy of community and regime remains intact despite occasional or perhaps frequent dissatisfaction with the performance of particular authorities occupying the regime.

Common to the approaches analysed above is an understanding that efficiency and democracy are two mutually reinforcing dimensions of legitimacy; only when the two are combined in a balanced manner can specific governance processes be legitimated over the long run. So far these accounts also focus largely on the domestic level of analysis. Easton's account of legitimacy in domestic political systems may be contrasted with the problem of legitimacy in a situation of global governance which takes place across overlapping multiple layers of institutions (national, regional, global), wherein the sense of political community and its acceptable shared norms is much weaker, the "regime" much more difficult to define, and "authorities" are spread unevenly across different layers of governance, depending on the state or community in question. In other words, institutions are weaker and more ephemeral, often recent in creation, and there is no underlying transnational community to match the transnational nature of governance and the problems with which it seeks to cope (Zürn 2004, 260). Decision-making processes are often more distant from traditional systems of (democratic) accountability, which may be seriously underdeveloped as a result. Cross-border economic and policy integration may furthermore disturb political communities and their norms and render regimes and authorities less efficient at coping with the demands of their

constituencies and producing a satisfactory reserve of legitimacy. Finally, this all means that *there is unlikely to be much in the way of Easton's diffuse legitimacy*. Global governance will be far more reliant upon performance and outcome, Easton's notion of specific support.

Thinking about legitimacy in the context of multi-level global governance therefore requires some adaptation of these concepts. Legitimacy at the international level is most frequently and not surprisingly considered as an extension of state sovereignty (Bernstein 2004, p. 3; Bull 1977), wherein state membership of international institutions and governance processes assumes that legitimacy is directly embedded in domestic political communities and regimes. However, where some states are more influential than others, and where lines of accountability and influence are not necessarily direct or clear, and where, as mentioned, responsibilities and competences in terms of governance are distributed across layers of institutions, this traditional conception is problematic. Furthermore, there is a distinction to be made between states and the people or constituencies they allegedly represent in international institutions. Some states are notoriously bad at representing their people, a considerable hindrance to the emergence of a sense of community and shared acceptable norms. One is tempted to argue that legitimacy will always remain obscure and necessarily problematic in such a context, but the literature does allow one to disengage a helpful analysis.

In the first place, while this article has claimed and will establish that cross-border integration and the development of global governance pose considerable problems for the legitimacy at the national level, it may also work the other way

around. A standard observation on international co-operation demonstrates the point: regional or global level governance helps to resolve collective action problems experienced by members of the international system, and to provide the collective goods which states acting individually cannot ensure. As Zürn has argued, "...international institutions give back to national policy makers the capacity to deal effectively with denationalized economic structures. Seen thus, international institutions are not the problem, but part of the solution to the problems confronting democracy in the age of globalization" (2004, p. 286).

Thus the fact that governance is spread across layers of institutions is not *per se* the problem. The problem is the accountability and legitimacy of such arrangements and (eventually) their link to democracy. An analogy with federalism helps one realise that sometimes the legitimacy of governance, especially of an acceptable sense of community (Easton), is *contingent* upon spreading governance across layers of institutions. It may be concluded that as long as global integration continues apace, legitimacy is unlikely to be enhanced *without* a more multi-layered system of global governance. The point is to establish institutions in such a way as to maximise sense of community, of accountability, of the norms of social justice, thus to enhance linkages to traditional democracy. Here one might borrow the distinction between *delegation* of authority to regional or global levels, and its *transfer* (Kahler and Lake 2003, 9-10). While legitimacy under conditions of delegation *may* be ensured through a direct link to sovereign state membership of the process, transfer certainly requires more robust attention to the inherent difficulties of legitimacy in a cross-border context.

If on this basis the proposition that ‘global governance is doing internationally what governments do at home’ (Finkelstein 1995, 369) can be accepted, there is a strong reason to draw an analogy with domestic political processes in which legitimacy is a basic feature of democratic rule and provides the normative underpinning for national governance. While domestic and international legitimacy may have different bases and patterns (Franck 1990), the legitimacy of global governance rests primarily on broad democratic principles (Held 1995; Nye 2001) which are not dissimilar to the underpinnings of legitimacy at the domestic level.

This last point invokes a conceptual understanding that legitimacy at all the levels of governance should be defined relative to the beliefs and values embedded in democratic political processes (Beetham 1991). Legitimacy defined in this sense suggests that the rules of global governance can be maintained only if states and their societies accept these rules as legitimate, to be obeyed voluntarily. Legitimacy exists and persists in the international system when processes and outcomes conform sufficiently to a prevailing system of norms. Furthermore, the acceptance of international rules can be facilitated and global governance improved if governments and transnational actors believe in the legitimacy of the rules and of the bodies and organisations that generate these rules. This reinforces the above proposition that legitimacy not only relates to the exercise of authority through democratic processes but also is contingent on the appropriateness of rules and standards that should be compatible with the existing specification of norms and values.

The legitimacy of global governance can therefore stem from the effectiveness of international institutions in providing global collective goods. In a democratic context, however, the legitimate authority to make and interpret rules should rest, first and foremost, on the institutionalised procedures and norms that are widely perceived as fair and just (Keohane and Nye 2001). This leads to the distinction between the input and output sides of legitimacy in national and international governance (Scharpf 1999; Wolf 2002). The input side refers to the extent to which the process of making political choices reflect the actual preferences of the community once defined. Input thus has to do with the way in which the interests of the broader community are included or represented in the policy-making process. The output side concerns results: the capacity of governance to produce outcomes which resolve problems and achieve collective goals in line with accepted and shared norms of the community.

It is argued that there is an uneasy relationship between the two. If the output is perceived as legitimate, it might not matter what the process was. Authoritarian regimes can produce consistently legitimate outcomes, at least for a time (dependent on the content of belief systems). Likewise, poor outcomes may undermine a legitimate process (financial crisis cannot always be the result), and the most legitimate process conceivable may consistently produce poor results which undermine diffuse legitimacy, whether related to circumstances that decision-makers can meaningfully influence or not. It should be noted that in a situation of global governance, where the sense of community and locus of authority is weakly defined, *output (or performance, Easton's specific legitimacy) is likely to be particularly important*. That said, a highly legitimate

(democratic) process with input from those who bear the costs of decisions is more likely to lead to acceptance of poor results over time, especially if the situation admits of little influence by decision-makers. A combination of both is most likely to contribute to strengthening diffuse legitimacy for institutions of governance and the occupants of positions of authority within a defined community. A final proposition, important for this discussion of global financial governance, is that *a more inclusive and legitimate process which represents a broad range of interests on the input side is more likely to lead to results embedded in norms which are perceived as legitimate on the output side*. In such a situation, conflicting norms more likely to be discussed and dealt with; better input will make it easier to enhance authoritative nature of even failed decisions. Process and interaction on the input side is closely linked to how the sense of community is defined, and over time should help emergence of sense of community with an accepted set of norms around particular issues.

On the basis of this last proposition, it will be argued below that strengthening the legitimacy of the input side of global financial governance is a reasonable starting point for improvement. One further point concerning the input side should be made, however. Strengthening input legitimacy of the process implies sound *representation* of the broad diversity of interests in the defined, if rather diverse, community, in this case of states and societies at various levels of development within the global financial architecture. Thus better representation is one way to enhance input legitimacy. This means recognising the various principles of representation which are available to

institutions of governance. These principles of representation sometimes conflict with and sometimes complement 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 institutions may be of differing economic and political import, leading to the principle of representing members differentially according to e.g. wealth, population, or territory. 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, a principle in conflict with one member, one vote. Yet 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), or debtors. A derivation of this in some contexts is interest-based or “corporatist” representation, where important and identifiable groups in the community are represented on the basis of their common interests *vis à vis* other competing constituencies. Finally one may invoke the principle of minority representation, where the purpose is to compensate the weak and to grant them a formal role in decision-making (Dorenspleet 2001). 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 here is that most systems of governance at the domestic or international level employ a *mix* of these principles depending on the context.

Returning one last time to the output side, political communities measure outcomes in a variety of ways depending on their systems of shared beliefs. Some shared norms may conflict openly with others, rendering tradeoffs among norms necessary, while others may more easily overlap compatibly. In relation to financial governance, some may prefer stability, others risk. Long run development and growth may be an accepted norm, perhaps rendered more difficult by preferences for social justice and reasonable distributional outcomes. One point is certain: claims to legitimacy are stronger in more coherent political communities. If outcomes are persistently unacceptable to a wide spectrum of the global or regional community involved in multi-level arrangements, then these regional or global mechanisms of governance will quickly be depleted of any accumulated legitimacy and may be fatally weakened. Local or national level communities may assert their claims more vigorously, leading to a decentralisation of governance which further undermines the capacity of national authorities either to cope with the problems of global integration or to commit to global governance, reformed or otherwise (Hiscox and Lake 2002, Garrett and Rodden 2003).

The stakes may be high. Extrapolating to the current state of global financial governance, both the input and output elements of legitimacy will be revealed as highly problematic and based on norms that are at variance with the political and economic imperatives of developing and emerging market countries in an era of transition to democracy, in some cases developed countries as well. As the dilemmas of global financial integration have been confronted, key aspects of international financial policy-making have become anchored in a discourse of

de-politicised technocracy that increasingly deviates from a range of norms compatible with democracy and which in large part reflects the preferences of an alliance between public and private financiers. The next section analyses the dilemmas and constraints presented by global financial integration and contemporary financial governance, and then relates the current financial architecture to the problem of legitimacy.

II. Global Structures, National Imperatives, and the Legitimacy of Financial Governance

This section supports the claim that the current global financial system exerts considerable pressure on national level policy-makers, creating dilemmas which conflict with a range of domestic political imperatives and render governance and policy-making more difficult. Secondly, this section will demonstrate how these constraints constitute problems for the legitimacy of contemporary financial governance at both national and global levels. The analysis will fall under three headings: the general constraints of capital mobility on the autonomy of national macroeconomic and social welfare policies; the changing balance between public and private interests; and the harmonising pressures of the system on national models of capitalism.

1. Capital mobility and political legitimacy

Capital mobility, as an increasingly prominent feature of the global economic order (Eichengreen and Fishlow 1998; IMF 1993), has limited governments' ability to make independent macro-economic decisions concerning fiscal, monetary and exchange rate policies. In an environment of high capital

mobility, autonomous macro-economic strategies relative to domestic imperatives require the sacrifice of exchange-rate stability, the degree dependent on the more vulnerability of the economy. Conversely, an independent exchange rate target may be maintained only at the cost of reduced control over monetary policy. Attempts by governments to affect national economic performance by following monetary policies diverging from international trends can lead to balance-of-payments disequilibrium, speculative attacks and exchange rate volatility (Andrews 1994; Kahler 1998; Webb 1991).

Financial integration affects in particular those national political economies reliant on external funds, most often those at various stages of a long-run development process. To benefit from foreign capital, they must provide a sufficiently attractive policy framework with a view to increasing market confidence in their economic policy (Haley 2001; Scharpf 1991). Seeking currency stability also reflects the desire of governments to avoid inflationary expectations which may lead market players to behave in ways that harm the real economy. As a result, there has been a tendency for policy to converge towards an agenda set by financial markets, with governments focusing more and more on exchange rate and monetary stability rather than other policy goals (Cerny 1996; Mosley 2003), with fiscal policy bearing the brunt of the resulting anti-inflationary stance. The prospects of rising inflationary pressures and currency instability associated with deficit financing are powerful disincentives against government attempts to run generous public spending programmes and counter-cyclical budget deficits.

These constraints lead to claims that financial integration has constrained the capacity of national states to provide the redistributive public goods associated with the social welfare state (Cerny 1995, 1996). While the literature has produced inconsistent results on this front,⁵ broad evidence that emerges from empirical case studies seems to confirm the validity of the claim that such policies are more difficult though not impossible. In many OECD countries, independent exchange rate policy has lost its role despite amplified risks of speculative attack while rising deficits circumscribe fiscal policy options. With national policies more constrained by financial market sentiment, pressures increase for cutbacks in public service spending and for the reversal of welfare policies traditionally associated with social democracy (Cerny 1999; Moses 1994, 1995; Rhodes 1998).

While financial globalisation has made it difficult for governments to sustain social welfare policies, the same structural forces subject broad segments of society to increasing market risks and dislocations and heightened feelings of economic insecurity (Agénor and Aizenman 1998; Dailami 2000; Stiglitz 2003b), thus augmenting political demands for enhanced social insurance and welfare spending. Furthermore, although financial integration tends to benefit holders of mobile assets and enhances their ability to hedge against market volatility, it generally leads to welfare losses of internationally immobile factors of production, such as domestically-oriented firms, labour and agriculture. This, together with reduced government intervention in market activities, has contributed to growing income inequality among different social groups within countries.⁶

While developed countries generally have not reduced the overall weight of welfare spending in the economy, large and rising public deficits have raised serious doubts about the sustainability of such spending (Garrett 2000, 123-5) and has contributed to a series of welfare state reforms. Governments perceive genuine political difficulties in raising taxes to match demands for spending in the context of financial integration. This has allowed business and finance to move with relative ease across borders and renders an important source of tax revenues precarious (Rodrik 1997b; Rodrik and van Ypersele 1999; Steinmo 1994; Williamson 2003).⁷ This perceived possibility of arbitrage amongst regulatory and tax regimes points to the difficulties governments have experienced in deploying redistributive taxation and welfare programmes.

Here there is an important and clear distinction between developed economies, to whom Mosley's "room to move" (2000) clearly applies, and (especially poor) developing countries, as encapsulated by the notion of "original sin."⁸ The marked decline in governmental receipts in many developing and emerging market countries suggest that they have experienced growing difficulty in imposing a stronger taxation on private capital, as it has become increasingly mobile and powerful against the backdrop of continued market-friendly reforms (Grunberg 1998; Stiglitz 2003b). Resort to deficits as alternative sources of finance pose the risk of destabilising the macro-economy and deterring private investment capital, so these states have been opted for cuts in welfare spending (Rudra 2002). Increasingly caught in the 'double bind' of growing pressures on public budgets and declining capacities to raise revenues (Grunberg 1998), developing states are less able efficiently to deliver welfare services and alleviate

the restructuring pains. Just when global financial integration has subjected domestic social groups to market dislocations, the ability of states to provide insurance against such dislocations has been weakened.

States themselves have in large measure authored these trends, with reforms in policy and state structures constraining the fulfilment of popular demands for compensation against the costs of global market integration.⁹ While talk of the rollback the role of the state is thus misdirected, the process has altered the balance of power between different state agencies, with significant implications for policy-making (Evans 1997; Sbragia 2000). Ministries that traditionally derived their bureaucratic power from the provision and management of welfare programmes have seen their position gradually decline in the continued process of privatisation and deregulation, whereas central banks and finance ministries have been increasing their power within the hierarchy of state agencies. Cautious about expensive social programmes, they are among the prime movers in the transformation of the welfare state for at least three reasons: they worry about the impact of fiscal policy on macroeconomic policy; they aim to ensure a positive climate for inward investment; and to avoid the negative impact of such programmes on the interests of their private constituencies in the financial community. As these “non-majoritarian institutions” (Majone 1997) have become more powerful and independent, the trend has both limited the institutional resources of and weakened the political coalitions which underpinned social protection against the often destabilising forces of global markets.

In short, the capital mobility associated with the contemporary financial system is a source of important limitations on the policy-making autonomy of states. Global financial integration has had consequences for state capacity in relation to a range of policies generally associated with the political stability and legitimacy of national governments. These difficulties have a particular impact on developing countries.

This tension between transnational financial constraints and growing domestic demands poses questions for political legitimacy, in particular the *output* side. States cannot consistently achieve results which correspond to the accepted norms of governance of their national communities. Given that the practice of legitimate governance is deeply rooted in (democratic) states as self-contained units, the *input* side of legitimacy is also engaged. Overall, the capacity to implement policies deemed necessary to ensure their political legitimacy in a democratic context is assumed (Coleman and Underhill 1998, 5-11; Held 1991; 1995, 3-23). Citizens hold authorities accountable for what they cannot fully deliver, with expectations becoming stronger as financial globalisation subjected a wide range of social groups to market dislocations and as democracy spread and consolidated in developed and developing countries.

The traditional concept of democracy has therefore been rendered problematic by the global scope of markets, which limit the competence and effectiveness of national political authorities (Held 1995, 127-34; Held and McGrew 1993, 268-71). Governments in most advanced industrial countries have begun to lose credibility with the majority of the population as they experience increasing difficulty acting in the interests and on the desires of their

citizens (Cerny 1999; Pharr, Putman and Dalton 2000). The problem is most acute in recently democratised political economies, including those emerging from communism (Freyberg-Inan 2006). In many developing and emerging market countries, the accentuation of already considerable socio-economic inequalities has led to dangerous pressures on emerging democratic governance (Armijo 2001; Karl 2000, 149-56).¹⁰

As argued above, shifting governance to the regional or global level is a possible solution to these dilemmas, yet the existing international financial architecture falls short. The norms and policies that constitute the new financial architecture have remained largely oriented toward upholding the virtues of free capital mobility (Armijo 2001; Soederberg 2001) rather than offering states the means of attenuating the difficulties it presents. While the sequencing of financial and capital account liberalisation is seen as important, the goal remains the same despite recognition of “original sin.” The process leading to this outcome is problematic here, dominated by the combined resistance of the US government, international investors and powerful domestic market players who have identified their political and economic interests with continued financial liberalisation and untrammelled capital movements (Cohen 2003; Soederberg 2001). Discussions about the impact of capital mobility on democratic development in emerging market countries have been totally absent from the official rhetoric on the reform of global financial architecture. G-7 governments and international financial institutions tend to view global finance as involving highly technical and private transactions that should be isolated from the uncontrollable process of democracy (Porter 2001).

2. Private power, accountability, and legitimacy

This section supports the claim that global financial integration and its architecture have also bolstered the position of relatively unaccountable private market actors in governance at both national and transnational levels. These private actors participate in a narrow and relatively closed policy community shared with the ‘non-majoritarian’ state agencies referred to above, in a situation which approximates policy capture. The market-based system as well as the debate on architectural reform has therefore tended to reflect the preferences of this policy community. Thus the outcome in terms of financial integration and its governance come from a process dominated by a narrow segment of society. This trend is part of a broader reconfiguration of the role of states as both promoters of market-based global integration and managers of the consequences, and does not imply that states are in retreat or could not implement alternative options. Once again this presents problems in terms of both the input and the output sides of legitimacy. The question is, can global financial governance be adapted to accommodate a broader range of interests and therefore more acceptable norms of governance, or will domestic reactions lead to a suboptimal decentralisation around individual national solutions?

A legitimate system of financial governance in a democratic context, appropriate to the imperatives of national economic and political development, requires a satisfactory balance of public and particularistic interests. Historical experience demonstrates that if financial governance is unduly dominated by profit-seeking private interests, there is a growing risk of financial crises and

problems for political legitimacy. Although financial transactions in market-based economies are largely private, the way in which the financial system operates as a whole makes it part of the essential infrastructure of any political economy, integral to the functioning of other markets, to the political needs of states and to the well-being of civil society, such that it must be firmly placed at the heart of the public domain.¹¹ These historical lessons were a priority for the 1944 Bretton Woods architects, and the agreements sought to ensure that private financial markets were at the service of national economic development and public policy objectives, so that financial instability would never again undermine the political legitimacy of emerging democratic countries.

Since then, new policies liberalising domestic financial systems promoted cross-border market integration, yielding a system characterised by a high degree of capital mobility (Cohen 1999; Helleiner 1994).¹² These developments represent a distinct change in the normative consensus achieved at Bretton Woods. With the process of financial globalisation has come a change in the balance of power between public authority and private market interests and the accompanying transformation in the notion of ‘public interest’ that defines the financial order.

Most governments have responded to the constraints outlined in the subsection above by adopting policies which reflect mobile agents’ preferences and reinforce the market principles of economic governance. Private market actors gain a stronger voice within the political system, often at the expense of broader sets of interests. Authorities have also reacted by adopting ‘market-based’ approaches to regulation, supervision, and corporate risk management

where private firms are responsible for risk management through complex mathematical models implemented under the approval of supervisory agencies (e.g. BIS 2006).¹³ Crucial information and expertise for the process remains the proprietary domain of firms which supervisors admit they cannot match. In a highly competitive environment state agencies also seek to improve market opportunities for national players by granting them greater freedom in product innovation and business expansion. This relative disarmament of public authorities has implied that private market interests increasingly define supervisory criteria, and that the crucial aspect of public policy, the safety and stability of the financial system, is dominated by the preferences of those private market makers who stand to benefit from it most.

Perhaps more important is how demands for these new systems emerged and were adopted. Financial firms and their associations have close and relatively exclusive relationships with regulatory agencies (for example, supervisors and central banks), with frequent delegation to self-regulatory processes. Most often statutorily independent from politicians and other state institutions, regulatory agencies are highly responsive to the preferences of private financiers, their main domestic political constituencies. In fulfilling their regulatory and supervisory functions, they draw much of their legitimacy, and work in close communion with, these private financial firms. Regulators also collaborate closely with national firms to adopt policies which promote competitiveness in the transnational market place. These close public-private ties are also reinforced by common professional norms, the specialised and technical nature of expertise in the financial sector, and the shared need to maintain public confidence in the

financial system itself. These symbiotic relations, prevalent across the G7 leading economies (Baker 2005), not only provide private interests with the opportunity to influence the nature of monetary and financial governance, but also the potential to capture policy-making and regulatory processes. Clear definition of the public interest distinct from the particularistic claims of private market actors in relation to the financial system has thus become increasingly difficult (Underhill 1995, 1997, 2000). Private interests allied with powerful state agencies have successfully pushed for the adoption of market-friendly policies based on their own particularistic preferences.

Furthermore, these same policy preferences are visible in international co-operative regimes and policies of the IFIs, indicating that G-7 governments have generally backed the preferences of their corporate sectors (Baker 2005) and that the policy community is increasingly transnational in nature. Market based supervision was promoted by the Group of Thirty, a public-private think-tank (Tsingou 2003), and developed by the Basle Committee on Banking Supervision, comprised of G-10 bank supervisors and central bank representatives, in close co-operation with the private sector lobby group the Institute for International Finance (IIF) (Claessens *et al*, 2003). Furthermore, co-operative institutions of global financial governance such as the Basle Committee or International Organisation of Securities Commissions (IOSCO), are characterised not only by exclusive policy communities, but also by virtual separation from any accountable political process (Underhill 1995, 1997), a problem further exacerbated by frequent recourse to self-regulation. As a result, the transnational financial system is increasingly regulated by agencies constituting *de facto*

private regimes centred in the financial markets (Cerny 1996, 96-9; Porter 1999), to become instruments of private economic interests rather than providers of collective goods.¹⁴

A wealth of evidence indicates that crucial multilateral IFIs such as the International Monetary Fund are part of this constellation of interests (Bhagwati 1998; Wade 1998; Stiglitz 2003a, esp. chs. 1 & 8). Private institutional investors have attempted to shape the investment environment in emerging market economies by pressing these economies to adopt policy frameworks favourable to their interests (Maxfield 1998; Porter 1999). This pressure is often reinforced by ‘advice’ from international financial institutions, especially the IMF, often at the moment when emerging market economies are most vulnerable to external pressures, such as during currency and financial crises. Developing country governments have found it increasingly difficult to deviate from the policy preferences of international financial markets, no matter how important particular policies may be for resolving their individual problems of economic development and socio-political stability.

Thus the emerging system of financial governance at national and global levels is flawed in important ways in terms of input legitimacy. The guardians responsible for making the rules of the financial market and governing the monetary and financial order are thus separated off from the traditional means of democratic accountability and control as well as influence from broader social constituencies. The point here is not that there should be no private sector involvement in financial governance. Close private involvement in financial policy management, official proponents of the new architecture claim, can

improve the transparency of the public and private sectors, foster better risk assessment, and limit moral hazard (Cline 2000; IMF 2001), thus facilitating the operation of a market-based system. Nor is the argument that the proper functioning of private markets, financial or otherwise, is contrary to the public interest. Yet a process encouraging private sector involvement is problematic if it fails to represent broader social constituencies, and aligns notions of the public interest with reducing risks for those who profit most from financial markets, limiting financial governance to technical co-operation to facilitate the market relationships.

The output side of legitimacy has also been flawed. Financial crisis and the difficult policy environment affecting developing countries has been one of the principal results of global financial integration. The decisions made in relatively unaccountable policy processes are often aimed at increasing the levels of transnationalisation and marketisation of economic policy making, benefiting private market interests at the expense of the well-being of the general public and further affecting the capacity of especially developing states to shape their political economies in line with democratic preferences. The dénouement of the Argentine crisis was the clearest illustration: there IMF conditionality in loan negotiations and private sector demands for debt workout directly confronted the outcome of democratic elections bringing President Kirchner into office. The outcome was extremely painful for investors and the economy alike, as Kirchner largely chose to follow his electoral constituencies.

Of course, recognised failures in terms of policy outcomes lay behind the will of the G-7/10, the IFIs, and a range of governments to debate and engage in the

reform of global financial architecture. Better global governance, in line with the arguments in the section on legitimacy above, could have alleviated some of the pressures of financial integration. Yet the results are disappointing, the outcome is not likely to be much different, and the reforms have done little to address or alleviate the legitimacy deficit. More radical proposals like Sovereign Debt Restructuring Mechanism (SDRM) were defeated. In this sense, the existing architecture for governing global finance has, worryingly, adopted a weak approach to the private sector. Focusing narrowly on the technical aspects of private involvement but neglecting its normative ramifications, it is most likely to be ill-suited to find the right balance between public interests and private gains in global financial management.

The growing dominance of financial governance by narrow private interests thus implies clear problems of democratic accountability. The implication for the governance of global finance is clear: the process needs to be more inclusive, representing a wider range of interests, and policy processes where private constituencies threaten or manifest capture must be rendered accountable to public authorities. Need one be reminded that international institutions and policy processes suffer from inherent weaknesses in terms of legitimacy in the first place, and that the stakes for states, their societies, and global governance are high?

3. Harmonizing pressures and national diversity

If the fundamental choices of states in key areas of policy and forms of governance are constrained, it follows that they have been increasingly unable to

defend the norms and institutions that history has, for better or for worse, conferred upon them and with which citizens understandably identify. The accelerated integration of national economies with international financial structures thus makes it difficult for states to sustain alternate models of capitalist development. Developing states in particular remain vulnerable to the aggregate behaviour of global investors who identify their interests with market-oriented policies and are able to pass direct judgement on local policy and business practices. This risk of volatile capital flows constitutes increased pressure for the adoption of the norms and standards developed outside the local variant of capitalism and compatible with global architecture. A major plank in the reform of global financial architecture was the promulgation of a range of “global” standards in the domains of macroeconomic policy,¹⁵ money laundering, financial stability, accounting, and corporate governance (Vojta and Uzan 2003). The process of convergence on these standards is not something that can take place overnight and can in itself prove destabilising to already weak political economies. It takes considerable time to develop the administrative and political capacity to implement such changes successfully, with possible unintended consequences (Caprio et al., 2001). It is unclear that these standards are appropriate to developing countries in the first place.

An obvious source of convergence is regulatory change in financial systems, a process which does not take place in a political vacuum. Indeed, states face constant political pressures for regulatory reform at domestic, inter-governmental and international levels (Underhill 1999; Vogel 1997). First and foremost, US and European financial institutions have been active in lobbying for deregulation

and aggressive in securing diplomatic support for their interest in access to relatively closed developing country markets.¹⁶ External pressures may also translate into new domestic regulatory preferences as national interest coalitions internalise external norms as states seek to attract capital and financial sector growth. These demands are often accompanied by domestic lobbies to deregulate forms of financial repression closely linked to a successful history of development and political stability. Such motivation certainly lay behind the 1980s reforms in many European countries and the 1990s liberalisation efforts among the East Asian and Latin American NICs. Finally, domestic regulators may find that their domestic firms are involved in international transactions, becoming drawn into international co-operative institutions such as the Basle Committee and IOSCO, where the preferences of developed G-10 political economies prevail over smaller and developing countries (Porter 1999, 2001). Furthermore, by containing some of the risks for transnational firms and promoting the norms governing financial market operations, these co-operative institutions have played a role in facilitating the liberalisation and integration of financial systems.

The result of these pressures has led to the acceptance and promotion of the market-oriented norms, standards, and practices in financial governance, whether appropriate to developing countries or not. If these pressures emanating from the G-7 treasuries (Baker 2005) can be sustained, one would expect national financial systems increasingly to resemble each other over time. Given that many successful developing economies have based their policies on systems characterised by financial repression, liberalisation may involve repetition of the

serious risks seen with the outbreak of the Asian Crisis (Haggard 2000; Zhang 2002).

While regulatory reforms conforming to global standards have precipitated changes in financial systems, the impact of global financial structures on state policy capacity and on the patterns of corporate governance and behaviour is yet more important for convergence. If the transnational integration of financial markets constrains the autonomy of state policy preferences in relation to domestic imperatives, the process also encourages states to make national markets more friendly to foreign financial institutions seeking an environment similar to that at home. Domestic reforms aimed at convergence on the norms of global financial architecture results. Though the degree of change has varied considerably among states, the result has been more market-based and liberal systems of economic regulation.

Similar motivations have led to the reform and convergence of corporate governance practices. Corporate governance and behaviour, as an integral part of any political economy, is closely linked to the type of financial systems and the relationships between the financial sector, producer firms, labour market practices and the state. In other words, differences in financial systems and corporate governance are central to what makes different models of capitalism different, and are part of the socio-political compromises which have characterised a particular political economy over time. Changes in the financial system may unravel these relationships to yield transformations in corporate governance, new (global) links between finance and industry, altered ties between labour and the employers, and thus a possible change in the

distinguishing features of economic development models themselves. The rapid transformation of systems characterised by financial repression can yield instability and crisis as well as convergence, further disturbing the social and political fabric.

As inducements for adopting harmonising rules and standards, the IMF has given a central role to two major instruments of external influence—conditionality and policy surveillance.¹⁷ The bottom line official consensus promotes structural reforms consisting of transparent macroeconomic policies, open financial markets, arms-length bank-industry ties, shareholder model Anglo-Saxon-style corporate governance, and market-led industrial adjustment strategies. These norms are argued to be of universal relevance despite national historical differences in financial and economic systems.

While there has been increased pressure for policy harmonisation, the convergence of economic models is far from inevitable, and this is part of the argument. Policy-making modes, financial systems and corporate practices are deeply embedded in the fabric of local legal, social and economic institutions, nationally-defined for the most part at the moment. Variations among national forms of capitalism persist to some degree as each local economy continues to refract external market and political constraints in its own way. Local constituencies will resist and may be successful in a number of ways, leaving room for the preservation of distinctive national policies and structures (Hay 2004; Pauly and Reich 1997). Historically, few paths to capitalist development have converged for long. The key point is, where the tensions between harmonising liberal market structures and local contexts and institutions become

overwhelming, capitalist development and a market-based society as such may prove politically unsustainable. If the harmonisation process conflicts with domestic socio-economic imperatives, the legitimacy of the reform programmes promoted by international institutions will be called into question.

The dynamic is as follows. Policy convergence to market-oriented policies intensifies competition among individual firms and favours multinational firms and mobile asset holders over domestically-based enterprises and internationally immobile factors of production (e.g. labour). This will result in considerable social and industrial restructuring, which some may well argue is beneficial in an aggregate and long-term sense, but involves important short-term costs for more vulnerable players. As their control over the policy environment diminishes *vis-à-vis* market forces, states are less able to alleviate the restructuring pains and to direct structural adjustment in line with domestic priorities. Furthermore, these effects on the patterns of welfare gains and losses among various societal groups pose a serious challenge to the existing mechanisms for income distribution, favouring policies against inflation as opposed to lower unemployment and other social welfare policies. The widespread efforts to increase the autonomy of central banks in many emerging markets over the 1990s and the associated tight monetary regimes made it difficult for governments to create new jobs; it was the poor in general and the unskilled workers in particular who suffered most from rising unemployment (Stallings and Peres 2000; Stiglitz 2000, 4-5).

Cross-country econometric studies have shown that income generated by the liberalisation and development of capital markets in developing countries tends to accrue almost completely to the top twenty-five percent of the population at

the expense of middle and low-income social groups (Das and Mohapatra 2003). These perverse redistributive effects of institutional reforms may then undermine political stability and growth prospects in developing and emerging market countries. Important empirical studies have demonstrated that those developing countries that were able to maintain high growth rates in the post-war period established effective political systems to manage social conflicts associated with market-oriented reforms and provide the vulnerable and poor with adequate social insurance (Alesina and Rodrik 1994; Rodrik 1998). In both developed and developing countries, complex political and institutional systems have emerged over time to manage distributional conflicts with varying degrees of success in different historical epochs and national settings. The contemporary instability of continuous adjustment to global market pressures, however, risks challenging these systems too rapidly for them to survive. Labour-capital bargains in European corporatist arrangements or employment-for-life in Japan, for instance, are being challenged as regulatory changes and increased capital mobility have enabled firms to seek an escape from their costly provisions. To the extent that these systems have contributed to socio-political stability and the legitimacy of national governments, constant adjustment to liberal market pressures and structures can sap governments of their political credibility and undermine the established patterns of legitimacy in democratic societies.

The pressures for convergence described above are cumulative, and the pressures of transition may be destabilising with disappointing economic results. There is thus little hard evidence so far that the end result of convergence would be a positive development *per se*. Many 'repressed' financial systems in Europe

and Asia proved themselves historically as policy instruments of tremendous efficiency and growth. The record of the global (and most national) economies since the advent of the financial integration process in the late 1970s has fallen short relative to the period of national control of money and finance following the Second World War (Crafts and Mills 1995). Despite reform, net capital flows to developing countries have remained unevenly distributed and volatile (frequently negative) over the years (Khaler 1998; World Bank 2006, 180-7), while total external debt has remained high (World Bank 2006, 193-9; 201-3). Even the national economy most successful at promoting global financial integration, the US, only recently emerged in the 1990s as a success story in terms of growth, yet has seen dramatic growth in inequalities at the same time (Krugman 2002).

It is difficult to argue that the emergence of the current architecture of global finance correlates to a long run improvement in the trend of leading economic indicators, to greater levels of financial stability, or to steady and greater access to capital for the world's poorer economies. The outcome has not been what advocates claimed. Once again, the result may be a decentralisation of global governance away from co-operation and towards incompatible sets of national or regional preferences.

One last point: the discussion above is no argument against the introduction of sound regulatory and corporate practices, but that international policy-makers must take local conditions into full account when pressing for reforms in emerging market countries. As it stands, however, the existing financial architecture has made little explicit reference to national legal, business and

political practices and institutions. While recognising differences in national financial and economic systems, the architects have not given adequate attention to the real and potential conflicts between those differences and their efforts to promote policy harmonisation. Nor have they fully realised the implications of those conflicts for national economic development and democratic governance.

In terms of legitimacy, once again a flawed process on the input side, representing an exclusive coalition of interests, has resulted in outcomes which are in tension with many norms of governance at the domestic level. That means that the norms of contemporary global financial architecture are shared by few, which undermines the effectiveness and perhaps the desire for international co-operation to resolve inevitable collective action problems. However, that the existing financial architecture has paid little attention to the clashes between policy harmonization and national differences and to their economic and political consequences represents not benign neglect but deliberate efforts to overhaul the institutions of development policies that have been deeply embedded in many East Asian and developing societies. In the wake of the Asian crisis, many economists of neo-classical persuasion breathed a sign of relief that these once successful exceptions to economic orthodoxy had finally met their come-uppance. For IMF leaders and US Treasury officials, the new architecture has been a means of altering the long-standing systems of economic development that often proved impenetrable to western corporate entities (Medley 2000). The destructive effects of structural reforms on the Asian financial systems and corporate practices may have been exactly what they hoped for.

The architectural reform agenda reflects not only the preferences of major financial centres and international institutions but also the interests of their major private sector constituencies. The danger is that structural reforms that have catered to the preferences of global investors in the name of ‘sound’ financial practices may be implemented at the expense of economic growth and political stability in emerging market countries.

IV. Normative Prerequisites for Global Financial Governance

The major argument developed in this article is that the technical aspects of governance, however important to international financial stability, must be substantively linked to the political and normative prerequisites of global governance. The architectural reform is unlikely to deliver what its proponents have promised until the international community has addressed these prerequisites directly. On the basis of the foregoing assessments, it is proposed that the appropriate and necessary modification to the prevailing official agenda should have the following features.

To summarise the findings so far, there are clear problems of legitimacy in terms of input/representation and output in global financial governance. It was argued in section I that in international governance, successful results providing Easton’s ‘specific’ legitimacy are particularly important, given the lack of ‘diffuse’ legitimacy of international institutions and their distance from traditional means of democratic accountability and community. But an inclusive process providing for the representation of a broad range of interests and employing a range of representational principles is also crucial for building a

sense of shared norms around institutions of global financial governance, a sense of community and better linkages to democratic and other accountability processes. Section II pointed out that global governance must leave sufficient room for domestic systems and a range of constituencies to adapt and develop their own solutions, thus preventing atomisation and disintegration of co-operative processes, in the same way that federalism reduces the chance of break-up of complex national communities.

Contemporary financial architecture fails on all these counts: the results are poor, and the process is flawed. The input from emerging market and developing economies has been at best constrained and marginalised, yielding financial governance in severe tension with the interests of these countries, as well as some social constituencies in developed countries. The architecture fails to preserve sufficient space for domestic democratic imperatives and choice in terms of national development trajectories. The legitimacy of political choices and governance derives from shared norms linked to the accountability of decision-makers to constituencies of citizens. In the international system, democratic accountability may be achieved and the legitimacy of global governance enhanced if states and transnational actors whose actions have an impact on the lives of people in other countries could be made more answerable to those people (Held 2002). While accountability can take varying forms, they all converge on a basic understanding that rule-makers should be responsible to broad publics (Keohane 2002). Using this basic understanding as a conceptual benchmark, the accountability of many transnational actors involved in the process of global financial governance remains questionable. Among these

actors, powerful states, international organisations, multinational corporations and inter-governmental and private-sector networks are often deemed the least accountable. Although some of these agents may be internally answerable to their own citizens, to member states, their shareholders or network members, they are unlikely to be held accountable to people outside their jurisdictions and policy spheres (Keohane 2002; Keohane and Nye 2001). Many developing and emerging market societies affected by the policy actions of the US government, the Bretton Woods Institutions (BWIs) or Western firms have no direct ability to hold these entities accountable. The influence these actors and organisations exert on the making financial governance, combined with their lack of ‘external accountability’ (Keohane 2000, 2002) undermines the efficiency and legitimacy of these rules and policies. While some scholars claim that the growth of supranational, private and technical authority in the process of global governance is a positive development for democracy (Porter 2002; Slaughter 2000), credible doubt remains. Unless these powerful actors and entities can be held externally accountable to broad publics in both developed and developing countries, the legitimacy of global financial governance is and will be called into question.

What is to be done? In the first place, national and international policy-makers should formulate technically effective measures to attenuate the worst effects of financial liberalisation and capital mobility. The rush to capital account opening and other forms of liberalisation played a significant role in the development of financial and corporate difficulties that were to follow. Although there is little evidence that open capital accounts contribute to growth

(Stiglitz 2000), and even according to the IMF, capital controls are demonstrably effective in certain contexts (IMF 2001), they still remain of the policy menu for largely political reasons (Cohen 2003a, 2003b). Emerging market authorities often liberalised rapidly as a result a combination of external pressures from IFIs and developed countries with limited understandings of local conditions, plus opportunistic pressure from some of their own constituents. Capital flows were liberalised but the necessary institutional mechanisms that might have acted as shields against the real and potential dangers of market integration were weak or non-existent, forgotten in the reform. This was a crucial causal factor behind the ensuing regional financial turbulence in Asia, Latin America and elsewhere.

While external policy advisors should avail themselves of the ample evidence that local political and institutional factors can make or break reforms, emerging market economies must eventually equip themselves better with policy instruments. The strong emerging consensus that capital controls should be, and indeed are, if implemented with caution, a workable policy instrument (Armijo 2002; Underhill and Zhang 2003) must find concrete expression in policy, giving governments the much-needed running room to compensate for the discretionary errors of policy which all governments make, and, more importantly, for financial market volatility. While few endorse comprehensive capital controls, substituting devices such as use of Chilean-style taxes on short-term inflows instead, proper restrictions on volatile cross-border capital movements are prerequisites for financial stability and sustained economic growth. Countries such as China, India and Taiwan managed to escape the regional contagion mainly because of the presence of capital controls (Breslin 2003; Joshi 2003;

Weiss 2000; Zhang 2003). Their ‘heterodox’ policy orientations reflected the national configuration of state and societal institutions and interests. Yet the resistance of the US government and powerful global financiers has made emerging market governments hesitant to embrace capital controls despite the evidence that they can indeed contribute to financial stability. Cohen (2003b) suggests it is necessary to build a more effective transnational coalition of proponents of capital controls as a legitimate tool of financial governance.

At the national level, most would argue that stability in the context of high capital mobility requires the adoption of enforceable financial governance standards for a range of public and private actors. The transparent and consistent application of such standards and other legal prerequisites underpin a business environment in which market transactions may take place without undue externalities or market failure. Institutional reforms have been proposed to facilitate the implementation of e.g. effective bank supervision and adequate auditing and accounting practices.

Yet designing and implementing financial standards is not without difficulties which must be *explicitly* addressed if the policies are to prove successful. National differences in socio-economic structures and institutions that underpin existing practices complicate the process of identifying and enforcing minimally acceptable standards. In addition, if one examines the historical record, *developed* economies attained success via a wide variety of paths to development and with a range of contrasting financial systems (Zysman 1983). Most had high doses of financial repression and financial governance which was less than a model for the current architecture, one might add.¹⁸ This

implies that there should be some latitude for the domestic implementation of international standards in such a way as to leave sufficient room for local practices and traditions and to allow countries to reform by different routes. Moreover, there is often entrenched domestic resistance from politically powerful actors who identify their interests with the status quo and thus attempt to convince regulators to interpret international standards generously. Given the high political stakes involved, global financial standards should be implemented cautiously and domestic political and institutional constraints taken seriously, allowing diversity in national market systems and development models and yielding slower reform but better long-run results for emerging market economies. The focus should be on ensuring functional equivalence of particular reform principles in specific contexts, not on a universal model. Socially optimal compensatory schemes and negotiating mechanisms should be established or reinforced in order to co-opt opposition to the reforms. The pursuit of micro policy innovations and associated institutional adjustments must be rendered compatible with the defining features of national economic governance and patterns of development in emerging markets. This extends to developing countries the same luxury which G-7 governments, especially the US administration and Congress, jealously guard, remembering that their own reform programmes happened over decades, and there were important mistakes made along the way. The more intensive the process of global financial integration becomes, the maintenance of micro-macro linkages will be all the more essential to the efficacy of democratic governance.

If countries with enduring difference in national economic models are to accept the costs which accompany these micro-macro linkages, then the institutions of global financial governance must command across their membership in their limited policy domains compliance similar to that achieved by domestic authorities in a national context. This implies mechanisms to deal with sovereign bankruptcy which command all parties, including rogue creditors.¹⁹ That also means compliance from those countries whose macroeconomic policies entail major destabilising international payments imbalances such as the US at the moment, not just countries afflicted with ‘original sin.’ This is most likely a major sticking point, as national governments display little enthusiasm for initiatives that would further compromise their policy autonomy.

The problem of co-ordinating compliance across such national diversity implies the importance of regional co-operative processes for managing the global monetary and financial system. As Hveem argues, regional solutions may be more effective than the nation-state on its own, with more potential legitimacy and collective identity than global institutions, thus perhaps more economically and politically optimal in terms of policy efficacy the sacrifice of national prerogatives (Hveem 2005, 301). At the regional level, emerging market governments may be more prepared to establish collective mechanisms for dealing with systemic instability, and may have more incentives to co-ordinate macro-economic policy, follow common rules over capital flows, contribute to the provision of contingency liquidity, and apply peer pressure to ensure compliance.

Structural reforms to facilitate governance at the national, regional, or global level involve a mix of official and private-sector actors and their interactions with public authorities at national and international levels. While private financial sector expertise can enhance governance, firms benefit the most from the market order whilst their financial transactions pose ongoing risks to the public interest. By implication, they should share the costs of crisis prevention, management, and bail-out, just as they benefit more than most in times of growth. While in most developed economies this has been accomplished at the national level, albeit not without a history of contestation, at the global level the obligations of firms are much less clear. To engage private actors and firms in responsible financial policy, a politically sustainable balance between public authority and private power should be an explicit concern of the reform of financial architecture. The ongoing potential for capture analysed in the public choice literature, and the empirical evidence presented above of real dangers of private capture of the policy process suggests that the clear definition of public interests distinct from the necessarily particularistic claims of private market actors is the key to ensuring the predominance of the public good in the financial system. Maintaining strong public oversight and control over private agents moreover implies effective subordination of private financial firms to democratic institutions and processes across levels of governance.

This involves looking closely at the policymaking autonomy of regulatory agencies from national to global levels. Where autonomous public agencies such as financial supervisors with delegated mandates maintain close interactive linkages to private financial firms and associations prone to particularistic rent-

seeking, governments should establish effective monitoring mechanisms in order to ensure accountability to their representatives and the electorate (Campos and Root 1997, 153-71; Haggard 1999). The power of private actors and potential for capture in situations of delegated authority should also be counteracted by including a broader range of social groups in these public policy processes and by fashioning more inclusive state-society relations (Biddle and Milor 1997; Evans 1997). Such inclusion will more likely lead to outcomes based on broader, shared norms in policy-making. Empirical evidence appears to cast doubt on traditional concerns that the inclusion of more social groups leads to the emergence of “distributive coalitions” and impairs policy efficacy (Campos & Nugent 1999; McCallum & Blais 1987; Unger & van Waarden 1999). These studies suggest that the expansion of interest groups associated with democratisation does not necessarily constitute a threat to growth-oriented policies, and that the relative organisational strength of business *vis-à-vis* other social groups (Lindblom 1977, 348-56) may prove less problematic if the state institutionalises interactive processes bringing civil society and labour together with private firms. To ensure the responsiveness of architectural reforms to the countries and peoples most affected by the reforms, key regional and international financial institutions should engage actively with transnational social forces (Held 1995; Woods 2001).

This raises the problem of representation as an element of legitimacy as discussed in section I. Different principles of representation accomplish different goals in political communities. The point once again is that input legitimacy could be substantially enhanced through better and broader

representation based on a range of principles, thus increasing the likelihood that a more acceptable spectrum of norms came to be shared in global financial governance. At the moment and to cite a specific example, representation in the BWIs is arguably based almost entirely on the not-very-democratic shareholder principle: who pays the piper, calls the tune. Even on this basis, a range of developing countries are grossly and systematically *under*-represented on this basis and a range of (particularly European) developed countries are considerably *over*-represented.²⁰ There could also be more control for size of population in voting systems, enhancing the voice of citizens of developing and transition countries representing some 84% of global population (Buirra 2005).

Other principles of representation could also be included in the system. At their founding, BWI member countries had proportionately much higher “basic votes” or one-member-one-vote elements in their votes, but quota increases have augmented the shareholder principle. Basic votes could be strengthened in relative terms. Furthermore, systematic the representation of “users” on the board could augment the representation of those with an ongoing adjustment programme. In this sense, debtors subject to conditionality as users of IMF services would receive more equal representation relative to developed country creditors, recognising that the causes and costs of debt crises are a shared responsibility, and that the poor in debtor countries probably bear the brunt of adjustment. A broader range of “corporatist” social partners across the membership could be explicitly represented. Finally, the minorities, the poorest mostly Africa economies subject to almost continuous IMF programmes since the 1960s could receive enhanced representation on the basis of the minority

rights principle. No political community is arguably legitimate without serious protections for minorities, and this 'minority' is also the most consistent 'user' or 'debtor'.

Linking a broad mix of these enhanced modes of representation to institutions of global financial governance with more developed political and administrative resources at regional and global levels is part of what has become known as 'cosmopolitan democracy'. By pooling sovereignty, attenuating the raw exercise of state and private corporate power through co-operative financial governance, 'cosmopolitan democracy' can attenuate some of the legitimacy deficit at the same time as it helps individual states to confront the tensions created by financial globalisation.²¹ This is of course easier said than done, and would certainly run into the fierce opposition of transnational corporate interests, which most enjoy the freedoms of global markets. Equally important, co-operative governance and the required abrogation of national prerogatives may be the most difficult hurdle (especially for the strong) in the development of (democratic) institutions of accountability at regional and global levels. These difficulties, however, do not diminish the potential advantages of the successful operation of cosmopolitan democracy, at the same time as current efforts at reforming global financial architecture fail to address the problems identified in the previous section. In the end, as at Bretton Woods, some resolution of the socio-political tensions and legitimacy problems associated with financial integration on the domestic front is needed, as are legitimate forms of global financial governance.

The G-20 and the Financial Stability Forum, in which only a dozen emerging market countries are included, have not produced genuine results to address the central concerns of the majority of developing countries (Akyüz 2000; Griffith-Jones, Ocampo and Cailloux 1999; Woods 2001). Any decisions made concerning the financial architecture are unlikely to have wide and lasting effects. The greater participation of developing countries and their societies is indispensable for their governments to justify the economic and social costs of structural reforms and to create the incentive for implanting international standards and practices within the national political economy. In order for the reform agenda to become more legitimate and therefore more achievable, developing countries will have to be given a major say in the setting of the agenda.

Conclusion

The analysis in this article has supported three propositions: i) that the external constraints of the global financial system are in tension with a range of potential domestic, particularly democratic, political imperatives; ii) global financial integration encouraged by developed states has strengthened the hand of private interests in the policy process, further constraining the definition of the public interest in a democratic context; iii) market-friendly institutional reforms both domestic and global put pressure on domestic socio-political arrangements underpinning longer run political legitimacy and sustainability of financial governance. Addressing these underlying problems requires explicit attention to the normative dimensions of financial governance.

The ten-year process of reform to contemporary financial architecture has fallen short of a fundamental restructuring of the ways in which global finance is governed, resulting in significant legitimacy deficits on the input and output sides. Although the new architecture has been deeply concerned with national policy changes, it has seldom confronted the political and institutional factors that underlie the substance or implementation of policy. While private market actors and agencies are increasingly integrated into international policy processes, the issue of a politically sustainable balance between public authority and private power at national and international levels has been ignored along with inequality and justice questions.

The argument here is that political legitimacy and democratic accountability constitute the real bottom line when it comes to the normative constructs of international financial architecture. If the system of financial governance and the conditionality governing the adjustment process conflict consistently with the mandates of democratically-elected governments and the requirements of domestic political stability, then the process of global financial integration and the architecture/policies which underpin it may be called into question or indeed unravel. This was certainly the case subsequent to the crisis of 1929 and the rapid disintegration of the international economic system, followed by a descent into political ugliness in a number of societies and eventual war. While the situation today is not as urgent, a number of countries already appear to be searching for alternatives. Without legitimacy, citizens' frustrations with democratic governance will deepen, extreme political movements intensify and global markets and institutions retreat (Pauly 1995, 1997, chapter 7; Strange

1998). Further integration of financial markets and the reform of global financial architecture should proceed cautiously so as to avoid a mass check-out from the 'Hotel Capital Mobility', leading to a situation where the collective action necessary for the successful governance of the financial system becomes impossible, with heavy costs for all in the global system.

¹ For more recent official discussions, see IMF (2003, 2005).

² See recent contributions by Kahler and Lake (2003), Soederberg (2004).

³ A few exceptions include Leslie Elliott Armijo (2003) and Susanne Soederberg (2003).

⁴ In the following discussion on legitimacy, the authors would like to acknowledge the research assistance of Emile Yesodharan, and the research project and MA thesis of Sylvia Tijnstra (2002), the supervision and completion of which inspired much of this discussion.

⁵ Prominent examples of econometric studies that lend support to the claim are Dani Rodrik (1997a; 1997b, chapter 4). The claim tends to be contested by Geoffrey Garrett (2000), and is qualified by Mosely (2000).

⁶ There is considerable literature that establishes the impact of economic and financial globalisation on the widening gap of wealth and income within both developed and developing countries. See, for example, Hurrell and Woods (1999), Dennis Quinn, (1997), Jeffrey G. Williamson (1996).

⁷ The general claim that financial integration reduces the redistributive role of corporate taxation is qualified by Garret's econometric analysis, which shows that the effects of integration on capital taxation are contingent on the partisan balance of power. See Geoffrey Garret (2000, 130-6).

⁸ See volume edited by Eichengreen and Hausmann, 2005.

⁹ Global financial integration is therefore not seen here as an alien phenomenon but as the result of deliberate policy led by interest coalitions within G-7/10 economies, embraced in uneven measure by developing countries, and largely supported by multilateral institutions.

¹⁰ It is acknowledged that the relationship between financial globalisation and democracy is necessarily complicated and defies simple and linear depiction. For a more nuanced treatment, see Sylvia Maxfield (1998).

¹¹ For a more detailed discussion on the notion of the public domain and corresponding interpretations of the public interest in relation to the financial order, see Underhill (2000).

¹² The domestic and international factors that prompted financial policy changes are not dealt with here. Relevant discussions of these factors include Goodman and Pauly (1993), Helleiner (1994), and Underhill (1991).

¹³ Some analysts cast serious doubts on whether market-based supervisory methods will lead to stability at all; e.g. see Persaud (2000).

¹⁴ Thomas Oatley and Robert Nabors (1998) document how the original Basle Accord was created to respond to the rent-seeking demands of private financial firms in leading industrial nations.

¹⁵ See IMF Reports on Observance of Standards and Codes for various countries.

¹⁶ This sort of pressure was greatly enhanced by the advent of and eventual conclusion of the WTO agreement on the liberalisation of trade in financial services (Dobson and Jaquet 1998).

¹⁷ The pros and cons of these instruments are examined at length in Devesh Kapur and Richard Webb (2000).

¹⁸ See e.g. Moran's (1986) account of the esoteric and anything but transparent nature of financial governance in the UK up to the end of the 1970s, or Bagehot's historic account *Lombard Street*. Neither Japan's nor Germany's financial sectors historically corresponded to the model

propounded by the contemporary financial architects, not to mention France, Italy, Korea, Taiwan, China, or a range of other highly successful economies. There was little regulation in the historically volatile and decentralised US financial system (Salley 2001), and financial repression was an important feature of US post-depression period, only slowly dismantled from the 1970s. It is difficult to think of a case of successful economic development based on the model propounded by current financial architecture.

¹⁹ One thinks here of the failed SDRM and other proposals.

²⁰ In terms of purchasing power parity, transition plus developing countries constitute the same share of world GDP as the G7, yet the G7 still has well over half of the IMF votes (Buirra 2005).

²¹ 'Cosmopolitan democracy' as a regional and global solution to the democratic deficit caused by economic globalisation is elaborated in James Bohman (1999) and David Held (1995, 267-82). On accountability, see Robert O. Keohane (2001).

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