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The Principles of Effective Global Governance:

Participation, Social Justice and Sustainability

David Held and Kevin Young[1]

The political tectonic plates appear to be shifting. With the failure of unilateralism in US foreign policy, uncertainty over the role of the EU in global affairs, the deadlock of global trade talks, the growing confidence of leading emerging countries in the world economy, and the worst international financial calamity the world has seen in 80 years, business as usual seems unlikely at the global level in the years ahead. It is highly improbable that the multilateral order can survive for very much longer in its current form, and a new configuration of possibilities is being created.

An increasing range of global issues are inadequately addressed. Global poverty and inequality remain at alarming levels; humanitarian crises continue to plague millions of people; widespread environmental destruction is depleting life chances across many parts of the world, and the ecosystem's capacity to sustain energy intensive lifestyles is coming under question. As the drama of the current financial crisis painfully unfolds, deeper and deeper systemic faults are becoming evident. These global challenges are indicative of three layers of issues we face: those concerned with sharing our planet (climate change, biodiversity and ecosystem losses, water deficits), sustaining our life chances (conflict prevention, poverty, global infectious diseases) and managing our rulebooks (finance and taxation, trade rules, intellectual property rights).[2] In our increasingly interconnected world, these global problems cannot be solved by any one nation-state acting alone. They call for collective and collaborative action – something that the nations of the world have not been good at, and which they need to be much better at if these pressing issues are to be adequately tackled.

The policy packages that have largely set the global agenda in recent years – in economics and security – are failing. The narrow Washington Consensus and Washington security doctrines – or market fundamentalism and unilateralism – have dug their own graves. The most successful developing countries in the world (China, India, Vietnam and Uganda, among them) are successful because they have not followed the Washington Consensus agenda, and the conflicts that have most successfully been diffused (the Balkans, Sierra Leone and Liberia, among others) are ones that have benefited from concentrated multilateral support and a human security agenda. Clues exist here as to how to proceed in the future. We need to learn from these clues and learn from the mistakes of the past if the effectiveness and accountability of the multilateral order are to be advanced. The need for fundamental change is clear, and has been increasingly acknowledged at the global level. The recent G20 summit in Washington and the UN Climate Change conference at Poznań symbolized an increasing recognition of the need for reform. But the weaknesses of both these meetings suggest the need to take global institutional reform much further.

While complex global processes, from the financial to the ecological, connect the fate of communities to each other across the world, global governance capacity is under pressure. Problem-solving capacities at the global and regional level are weak because of a number of structural difficulties which compound the problems of generating and implementing urgent policies with respect to global goods and bads. These difficulties are rooted in the post-war settlement and the subsequent development of the multilateral order itself.[3]

To put the point bluntly, the problem solving capacity of the global system is in many areas not effective, accountable, or fast enough to resolve current global dilemmas.[4] What has recently been called the paradox of our times[5] refers to the fact that the collective issues we must grapple with are of growing extensity and intensity and yet the means for addressing these are weak and incomplete. There are a variety of reasons for the persistence of these problems, but at the most basic level the persistence of this paradox remains a problem of *governance*. One significant problem in this regard is that a growing number of issues span both the domestic and the international domains. The institutional fragmentation and competition between states can lead to these global issues being addressed in an ad hoc and dissonant manner. A second problem is that even when the global dimension of a problem is acknowledged, there is no clear division of labor among the myriad of international institutions that seek to address them: their functions often overlap, their mandates conflict, and their objectives often become blurred. A third problem is that the existing system of global governance suffers from severe deficits of accountability and inclusion. This problem is especially relevant in regard to how less economically powerful states and, hence, their entire populations, are marginalized or excluded from decision making.

The paper that follows focuses on three major global public policy challenges which together form a substantial part of what can be referred to as the global commons: the collectively shared domains that tie diverse populations, interests and concerns together into a global community of fate. First, the serious challenges associated with the global financial system are examined through a focus on the need for stronger institutional governance capacity and participatory reform. Second, the shared global security environment is explored. The demonstrable failure of unilateralism and the recognition of the need for security in a much broader sense - security from poverty, disease, and joblessness - call for a security agenda that places social justice at its core. Third, the threat to the natural environment posed by climate change and the inadequacy of the current efforts to manage climate change are set out. In each domain, the paper describes how specific global public policy dilemmas are being approached today, and how governance solutions have failed, with momentous consequences. However, the aim is not only critical.

Through the examination of these three domains, the paper shows that increased participation, the prioritization of social justice, and a focus on sustainability are not just critical values for a better world, but core operating principles for effective global governance. In the final section of the paper, proposals are set out for a new global deal – the reforms required to address the key global issues we face and to provide the means to bind states and communities into a new set of rule based global arrangements.

Financial Turmoil and Financial Governance

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

There are many factors at play in the recent global financial crisis – the buildup of the financial market bubble, the failure of central bankers to track adequately for house asset price inflation, the near universal incapacity to detect systemic risk, the powerful private authority of private sector actors to increase the riskiness of their institutions – to name but a few. These contributing forces are highly complex, and are outside the scope of this paper to discuss. What can be said is that the existing system of global financial governance failed in a momentous way. What is more is that global economic interconnectedness has meant that the costs of governance failures are widely dispersed across extremely vulnerable segments of the world population. Recently it has been estimated that as many as 80 million more people could be forced to live in extreme poverty as the result of the recent global financial crisis; this figure is double what was previously feared.[6]

To be sure, the existing system of global financial governance has some successes to its name. Punctuated periods of international financial stability in the past have produced political demand for, and modest deliverance of, coordination between sovereign financial authorities. Like well known institutions such as the World Bank and the International Monetary Fund, the Bank for International Settlements has been transformed over the decades to meet a variety of contemporary concerns, acting as a hub for the increasingly important function of central bank cooperation, research, and policy dissemination. Since the reemergence of international financial markets in the early 1970s, financial supervisory authorities from the G10 nations have coordinated common rules and standards for banking cooperation through the Basel Committee. The Financial Action Task Force has successfully moderated the global flow of illicit funds and assisted with the tracking of terrorist finance. After the East Asian financial crisis of 1997-8 shook international markets, the Financial Stability Forum (FSF) was established to push the extent and form of cooperation further. Together these institutions have in some respects limited financial regulatory competition among states, strengthened the multilateral capacity to react when problems arise, and provided a much needed institutional capacity for present and future purposes. They have facilitated financial globalization and acted in many ways to manage it through cooperative efforts at the international level. The existing system of global financial governance has, moreover, provided emergency liquidity to countries in times of financial stress, provided a global framework for international banking regulation, combated international money laundering, coordinated monetary policies, and provided forums through which national financial authorities can be encouraged to develop best practices.

Yet the failures of this system of global financial governance are even more striking. First, the existing system is composed of institutions which developed in response to specific problems that arose over the last 35 years associated with the reemergence of global finance, and have transformed themselves since then to broader purposes which now overlap. Subsequently, while these institutions can work together on occasion, there is no clearly defined division of labour among them. Compounding this problem is the fact that the governance of financial markets is an issue which spans both the domestic and the international, and fragmentation and competition between states has led to these global issues being addressed in partial and even erratic ways.[7]

Even when systemic problems have been identified, proportionate action has not been taken. For example, in 2007 the BIS recognized several structural problems with the international financial system, but this recognition remained at the level of research and observation, rather than action.[8] More recently, the Rome meeting of the FSF in March 2008 and its subsequent recommendations delivered to the G7 Finance Ministers and Central Bank Governors in April identified a number of key weaknesses underlying the financial system, and recommended provisions for some substantive reforms. The FSF ambitiously drew up provisions to strengthen prudential oversight of capital, liquidity and risk management, enhance transparency and valuation methods, revise the role and uses of credit ratings, and strengthen state capacity to respond to risks. While some of these provisions are being taken seriously today, at the time they failed to estimate the systemic nature of the crisis, and it took the urgency of a deepening crisis to have the implementation of their recommendations command real attention and debate.

Worse still, most international financial institutions have promulgated an exclusivity in dealing with problems which are, at the end of the day, global. Most institutions of global financial governance have an extremely regressive approach to accountability and inclusion. Despite some minor reforms of the last year to its voting rules, the IMF remains locked into a system that ensures strong US dominance of the institution. This does not just ensure that its policies reflect existing biases within US domestic politics at any given time, but means that the Fund is unable to secure sufficient sources of funding to widen its capacity and scope. What incentive do states outside the G10 have to contribute more to the Fund under these circumstances? The Basel Committee designs the de facto banking regulatory rules for the world – and yet its composition looks increasingly arbitrary.[9] Why should such a small, select group design common banking regulations that are the de facto standards for the whole world? Australia, Brazil, India and South Korea all have private banking capital that far exceeds that of many Basel Committee members. Not only do such emerging economies suffer the negative consequences of the decisions and non-decisions of the Basel Committee, but so does virtually every other country in the world.[10] The Basel Committee has expanded the diversity and breadth of parties it consults with, but ultimately decisions for the world are still made by the same exclusive group of countries.[11] A similar problem plagues the FSF. While its membership includes a number of different kinds of institutions, effectively the FSF is a G7-based organization. The recent G20 summit in Washington saw an unprecedented attempt to engage in participatory reform by admitting countries such as China and India into the Financial Stability Forum. It does represent a significant change. But it is only a very small step. Developing countries had to fight and advocate for this, and they will have to do more.

No global reform process can be fully effective if it does not arise from a process that is highly inclusive of developing and developed states. As Supachai Panitchpakdi, Secretary General of UNCTAD has pointed out, while few developing countries have been directly exposed to securitized mortgages or failed US financial institutions, the vast majority of them will be significantly affected indirectly through reduced availability of credit, stock market panics, and the slowdown in the real economy. Again, the participatory principle (see our discussion of equivalence, below) must take centre stage: not simply for reasons of equity, but for reasons of effectiveness.

While a system of global financial governance exists, it is not comprehensive or powerful enough to tackle large systemic level financial risks. Participatory reform within the existing institutions could give voice to states and actors that have a greater interest in protection against systemic instability, rather than a stake in risk-taking through profitable financial instruments. The existing system of global financial governance has demonstrably failed to generate the conditions for systemic stability. The regulatory forbearance toward credit default swaps, collateralized debt obligations, and over the counter derivatives did not represent a ‘blind spot’ of the existing regime of governance. It represented a distinct choice and a policy failure *not* to act to address booming but potentially volatile patterns of financial market development. The faith in light regulatory stances and enhanced firm autonomy in the regulatory process has been severely discredited.

Insecurity and the Need for a New Global Security Agenda

If the global financial system integrates a common infrastructure for the distribution of capital, the international security system ensures an arrangement for the management of conflict and violence. This domain of our shared existence, like the others discussed here, does have an existing set of institutions and rules which govern it. Yet, the currently dominant model of security provision is outdated and ineffectual at meeting its objectives. Furthermore, the recently flourishing doctrine of unilateralism has many serious implications.[12] Among these a return to an old realist understanding of international relations as a sphere in which states rightly pursue their national interests unencumbered by attempts to establish internationally recognized limits (self-defense, collective security) on their ambitions. In this context, one might fairly ask, if this 'freedom' is (dangerously) granted to the US, which has championed it under the Bush Administrations, why not also to Russia, China, India, Pakistan, Israel, Iran and so on? It cannot be consistently argued that all states bar one should accept limits on their self-defined goals. The flaws of international law and the UN Charter system can either be addressed, or taken as an excuse for further weakening international institutions and legal arrangements.

The model of unilateralism has been met with general failure. After 9/11, the US and its allies could have decided that the most crucial objective was to strengthen international law in the face of global terrorist threats, and to enhance the role of international institutions. They could have decided it was important that no single group or power should act as judge, jury and executioner.[13] They could have decided that the disjuncture between economic globalization and social justice needed more urgent attention, and they could have decided to be tough on terrorism and tough on the conditions which lead some people to imagine that Al-Qaeda and similar groups are agents of justice in the modern world. But they have systematically failed to decide any of these things. The world after 9/11 has become a more polarized place, with international law weaker, and multilateral institutions more vulnerable.

The War on Terror killed vastly more innocent civilians in Iraq than the terrorists on 9/11, humiliated and tortured many Iraqis, created numerous innocent victims, initiated a massive displacement of people, ignited sectarian violence, and acted as a spur to terrorist recruitment. It showed little, if any, understanding of the dignity, pride and fears of others, and of the way in which the fate and fortune of all peoples are increasingly tied together in our global age. Instead of seeking to extend the rule of law, seeking dialogue with the Muslim world, strengthening the multilateral order, and developing the means to deal with the criminals of 9/11, the US and its allies (notably the UK) pursued old-war techniques which have made nearly everyone less secure. Although recent changes in military strategy and tactics associated with General Petraeus have helped stabilize and contain the conflict and violence in Iraq, the situation on the ground remains highly insecure and volatile.

However, the problems of international security run deeper than disregard for effective multilateralism and the dominance of the Bush doctrine. The very instruments of international security provision are perversely oriented for a world that we no longer live in. Most of our military organizations are national armies. Our military capacity and technologies are all geared to fighting wars in terms of combating physical forces in discrete space and time. At the present time, this model cannot deliver in many areas where security is most needed – and as such there is a need to create military capacity which is based on cooperation and collaboration of armed forces. This poses not only important questions about the collaboration of, and sharing of, personnel, technology and intelligence. It also poses serious issues about how to link international security to human security more broadly – through commitments to sustainable development and social justice. The emphasis has to be not just on fighting wars, but securing the safety of human beings more generally.[14] A new global deal that encompasses human security as its foundation would take into account the legitimate concerns of the developed Western world, but also recognize that for the majority of the world's population the main impediment to their security is not political conflict, but material deprivation on a massive scale. The progressive way forward involves almost the opposite of what has been promulgated over the last decade; that is to say, the development of a human security agenda that is based on multilateralism and common rules, which seeks order through law and social justice, which seeks to re-link security and the human rights agenda, which seeks to strengthen global governance, and which aims to make the world safe for humanity, with global justice and impartial rules.

A human security agenda requires three things of governments and international institutions - all currently missing.[15] First, there must be a commitment to the rule of law and the development of multilateral institutions - not the prosecution of war as the first response. If justice is to be dispensed impartially, no power can arrogate to itself the global role of setting standards, weighing risks, and meting out justice. What is needed is momentum towards global, not American or Russian or Chinese or British or French, justice. We must act together to sustain and strengthen a world based on common principles and rules.[16] Second, a sustained effort has to be undertaken to generate new forms of global political legitimacy for international institutions involved in security and peace-making. This must include the condemnation of systematic human rights violations wherever they occur, and the establishment of new forms of political and economic accountability. This cannot be equated with an occasional or one-off effort to create a new momentum for peace and the protection of human rights, as is all too typical. Finally, there must be a head-on acknowledgement that the global polarization of wealth, income and power, and with them the huge asymmetries of life chances, cannot be left to markets to resolve alone. Those who are poorest and most vulnerable, linked into geopolitical situations where their economic and political claims have been neglected for generations, may provide fertile ground for terrorist recruiters.

Of course, terrorist crimes of the kind witnessed on 9/11 and on many occasions since in Chechnya, Indonesia, Saudi Arabia, Pakistan, Morocco, Spain and India are in part the work of the fanatic and so there can be no guarantee that a more just and institutionally stable world will be peaceful in all respects. But if we turn our back on the project of creating such a world, there will be no hope of ameliorating the social basis of disadvantage experienced in the poorest and most dislocated countries. Gross injustices, linked to a sense of hopelessness, will then feed anger and hostility. Popular support against terrorism depends on convincing people that there is a legal and peaceful way of addressing such grievances. Without this sense of confidence in public institutions and processes, the defeat of terrorism becomes a hugely difficult task.

Global Governance and Climate Change

The failure of the international community to generate a sound and effective framework for managing global climate change is one of the most serious indications of the problems facing the multilateral order. Until the middle of the last century, most forms of negative environmental impact were largely localized. Since then, the impact and scale of environmental change has dramatically intensified. Sixty years of resource intensive, high pollution growth in the OECD, and the even dirtier industrialization of Russia, Eastern Europe and the ex-Soviet states have taken their toll. Recently China along with other countries in the developing world are putting further pressure on non-renewables and the natural environment. The problem is quintessentially global. The former British chief scientist Sir David King has warned that climate change is the most serious problem we are facing today, even more serious than the threat of terrorism.[17] Irrespective of whether or not one agrees with this statement, global warming in the broad view of the scientific community has the capacity to wreak havoc on the world's diverse species, bio-systems and socioeconomic fabric.[18]

The efforts to identify and combat global climate change are a direct function of the diverse configurations of power that characterize global governance. In this regard, not only states through multilateral cooperative efforts, but civil society networks have played a prominent role in pushing this issue onto the global agenda. The effort to outline environmental sustainability criteria into international trade negotiations is a case in point. The creation of the WTO Committee on Trade and the Environment, and the Hong Kong Ministerial round of WTO negotiations, for example, saw some of the most extensive discussions on this matter to date. More recently, the WTO-UNEP collaboration on trade and the environment at the UNEP's Global Ministerial Environment Forum in Nairobi in February 2007 represents a further step in this direction. Nonetheless, despite some progress, the way in which environmental issues are addressed at the international level remains inadequate. Like other pressing global public policy challenges, the threats posed by global climate change are vastly greater than even those relatively coordinated efforts currently existing at the global level.

The existing efforts to address global climate change suffer from familiar deficits in the current system of global governance. While a number of individual international environmental agreements exist, and may even possess admirable characteristics, they are often both weakly enforced and poorly coordinated amongst each other. Furthermore, they are supported by a plethora of different international organizations fulfilling various functions. The current global environmental governance regime features a diverse set of players whose roles are largely uncoordinated among each other: the UN Environment Program, the Global Environment Facility, the Environment Management Group, the OECD Environment

Directorate, the Commission for Sustainable Development, ECOSOC, and the Environmental Chamber of the International Court of Justice, to name the most prominent. The current constellation of over 200 international environmental agreements suffers from a problem of what might be called 'anarchic inefficiency.'

The contemporary system of global governance has in some ways led to important successes in the efforts to deal with a variety of environmental issues. The Kyoto Protocol, signed in 1997, was a step forward in trying to regulate greenhouse gases, yet the United States, the biggest single contributor to greenhouse gas emissions at the time, refused to sign.[19] The UN conference in Bali at the end of 2007 was another crucial step forward in establishing broad commitments to seek a new globally shared framework of action on climate change by the end of 2009. One of the successes of Bali was the agreement that a global deal on climate change would require commitments to be measurable, reportable, verifiable, and binding through the terms of an international treaty. The commitments to an Adaptation Fund in order to assist developing countries in mitigating carbon emissions was another significant move forward, a move further advanced most recently at the Poznań conference. But there is a very long way to go to establish a new global deal for climate change, and it is not at all clear that the international negotiations scheduled for Copenhagen in 2009 will succeed in cutting carbon emissions fast enough and laying the foundations for a new low carbon world economy.

As with global finance, accountability and inclusion represent serious challenges to addressing the problem of climate change. Paramount in this challenge is the inclusion of less developed countries in international commitments. Poorer developing countries very often lack the resources, capacity, and technology to come into compliance. This is not only a problem of inequality of resources. It also reflects the inequality of access to decision-making in international institutions, which often puts developing countries on the defensive when new sustainability initiatives are proposed.[20] Any future agreement cannot simply build on the traditional burden sharing approach of dealing with a problem inherent in the global commons: given the scale of transformation that is required for a sustainable future, wealthy industrialized states must bear part of the cost of the transformation in developing countries. There are already some mechanisms for this through the Clean Development Mechanism, but they need to go much further.

Existing momentum on climate change policy requires escalation if sustainability issues are to be addressed adequately over the next few decades. The challenge is how to link sustainability with enhanced participation and social justice. Protecting the global commons of our climate demands an approach that is equitable – not simply as an end in itself, but as a means to the end of effectiveness. The integration of less developed states is absolutely critical, since even if the developed states of the world were to cut their emissions to zero by 2050, without significant cuts in the rest of the world the overall goal would be missed. An international agreement to address climate change is crucial to the goal of sustainability. In order to be effective, any new global deal must be equitable in a very particular sense; it would have to require commitments from individual states to be graduated according to stages of economic development.[21] Halving global emissions by 2050 would thus entail proportionate adjustments, with highly developed states decreasing their carbon emissions by 80%.

Political Opportunities for a New Global Deal

There are a number of potential opportunities created by the current conjuncture of pressures in finance, security, and the environment. First, as socially and economically devastating as the fallout from the global financial crisis is, it also provides important new openings for the reform of governance. On the one hand, the once authoritative Washington Consensus-based policies of deregulation and exclusive market-leading growth strategies have revealed yet more of their limits. Especially in the realm of finance, the opportunities for change are wide given not only the demonstrable failure of existing institutions to detect and prevent crisis, but also given the geopolitical origins of the current financial crisis. The negative effects of the crisis emanate squarely from the Anglo-American core of the global financial system: especially the financial sector of the USA. Additionally, any remaining semblances of doubt that individuals around the world are interconnected through their common relationships to financial flows can be put to rest. Thus the question inescapably arises: if the governance of private financial markets affects life prospects in profound ways, why is finance not governed more effectively? Proposals for global-level change have recently come onto the agenda and have been widely supported by previously uninterested electorates. In this context, the proposed IMF reform at the G20 summit, as well as the expanded inclusion of emerging economies into the FSF, create some grounds for optimism.

Some important opportunities exist in the changing geopolitical configuration of power as well. The pressures for the new Obama Administration to remake a multilateral engagement with the rest of the world bode well for a number of different global public policy domains. The new leadership in the USA is clearly eager for a reformed international order. Commitments to dealing with climate change, financial sector reform, and security are all on the tentative agenda. Moreover, in all three of these global public policy domains, newly emergent geopolitical powers such as Brazil, India and China are clearly poised for more extensive involvement at the global stage. While there are clear challenges of integrating such diverse interests into a system of global governance that can function effectively, the costs of alienating any of these states and their peoples is now simply too high. Their political integration must be made a priority for the currently dominant geopolitical powers. The demand both within many official quarters of the EU institutions and among many EU citizens for an increased role in world affairs can act as an important complement to these forces.

A new global deal could take as its animating principle the concept of *a global commons* – not only a shared set of resources, but a shared community of fate, the very basis of contemporary globalization. As its normative core it could enshrine the *principle of equivalence*: that is, that the span of a good's benefits and costs should be matched with the span of the jurisdiction in which decisions are taken about that good.[22] At its root, such a principle suggests that those who are significantly affected by a global public good or bad should have some say in its provision or regulation. Such a principle of equivalence could be circumscribed by a concept of the right to protection from grievous harm. In this way, all-inclusiveness would require deliberation and engagement in policies that seriously affect life expectations and chances.[23]

In the domain of global financial governance, the current deficiencies are striking and yet the potential for change is also profound. A very sophisticated but ultimately ad hoc system of global financial governance has been no match for the systemic failure witnessed during the past year. In order to be fully effective, an increase in authority of financial governance institutions must be coupled with an increase in accountability. The recent G20 meeting in Washington saw an important step forward in attempts to reform global financial governance. Many world leaders – especially in Europe – have called for substantial reforms the likes of which until recently only a handful of academics and activists were advocating. If any of these reform proposals are to be implemented, one element will be crucial: adding institutional capacity. The existing institutions of global financial governance each have significant resources and expertise which could be called upon to address the diverse demands of the G20 summit and beyond. Yet any reform agenda geared to balancing the two worlds of financial globalization must simultaneously tackle the divide between the rich countries of the world that have dominated the existing system of global financial governance, and their developing country counterparts that have shared the costs, but have had, up until recently, little hand in shaping it.

As a basis for a new global deal in financial governance, the most significant step is to dramatically expand the scope for participation and engagement. Instead of governing according to wealth, global financial governance should be governed by the principle of a global commons. The principle of equivalence as outlined above should apply in this context. Full participation of stakeholders is more than a means to legitimacy. It can also help to underwrite effectiveness. In areas of global governance that seek to protect or promote the provision of a global public good – such as global financial stability and soundness – there are inherent problems when that public good is protected by a minority of stakeholders. This is because in such cases a minority group does not suffer the full consequences of its actions when it is ineffective in its governance.[24] When the costs of financial crisis are distributed so widely, what incentive does an in-group of governing institutions have to reform its practices? Certainly they have some – but the danger is that any response will still be too weak, too uncoordinated, and too modest for the task at hand. Concrete proposals could be to raise the profile of the UNCTAD's review of the Monterrey Consensus, and in doing so underline the positive relationship between fuller participation and effectiveness in global financial governance. ECOSOC could be encouraged to speak out on global financial governance issues more boldly, offering a counterweight to many of the institutional biases within the existing system.[25] Proposals for participatory reform could be encouraged not only to focus on the IMF and the World Bank[26] – institutions that only compose one part of the system of global financial governance – but also on other important institutions such as the BIS, the Basel Committee, and the Financial Stability Forum.[27] ECOSOC or other international bodies with systems of accountable representation could review the process of participatory reform in each of these institutions. Current momentum to design a global college of financial regulators might consider proposing realizable steps toward the longer term goal of the creation of a World Financial Authority.[28] Reforms to the system of global financial governance in the years ahead will have to build on institutions already in existence to a significant extent. This is why participatory reform is so vital at the moment. Yet longer term solutions for effective governance will require centralized coordination and authority, especially once financial markets experience a resurgence, and with it a re-strengthening of private financial power.

In the area of international security, a human security agenda can be proposed. First, this would include re-linking the security and human rights agenda in international law – the two sides of international humanitarian law which, together, specify grave and systematic abuse of human security and well-being, and the minimum conditions required for the development of human agency. Second, the UN Security Council must have reformed procedures to improve the management of armed intervention in the affairs of other states. The objective here would be to link this procedural change directly to a set of conditions which would constitute a severe threat to peace, and/or a threat to the minimum conditions for the well-being of human agency, sufficient to justify the use of force, and which would lock the deployment of force into a clear framework of international humanitarian law. Third, a new global deal would recognize the necessity to amend the highly outmoded 1945 geopolitical settlement as the basis of decision-making in the Security Council, and to extend representation to all regions on a fair and equal footing. Fourth, with such improved representation and legitimacy, the UN Security Council could have its remit expanded or, alternatively, could work to create a parallel Social and Economic Security Council, to examine and, where necessary, intervene in the full gambit of human crises – physical, social, biological, environmental – which can threaten human agency.

A global security agenda should take great care how it is elaborated, let alone implemented. If the developed world wants rapid movement to the establishment of global legal codes and mechanisms to enhance security and ensure action against the threats of terrorism, then they need to be part of a wider process of reform that addresses the insecurity of life experienced in developing societies. Across the developing or majority world, issues of justice with respect to government and terrorism are not widely regarded as a priority on their own, and are rarely perceived as legitimate unless they are connected with fundamental humanitarian issues rooted in social and economic well-being, such as education, clean water and threats to public health.

As part of a new global deal, an integrated and ambitious human security agenda would seek to complement many of the challenges of environmental sustainability. What the global public policy challenge of climate change needs is not just advocacy and attention, but coordinated action and authority. As in many cases of multilateral cooperation, the fruits of this cooperation result in agendas and agreements, but with no teeth to them, no clarity, and only modest action at best. A now familiar equilibrium pattern has emerged: various actors in global governance converge in their agendas just enough to claim some marginal progress for their constituencies, but not enough to fundamentally resolve the issue at hand or provide a sufficient way forward. A new global deal could propose the founding of a World Environmental Organization in order to promote the implantation of existing environmental agreements and treaties, and whose main mission would be to ensure that the development of the world trading systems are compatible with the sustainable use of the world's resources. Delegating some authority to scientific bodies within such a new organization could help dissolve some of the geopolitical conflict that occurs when dealing with the management of emissions in the context of vastly disproportionate levels of industrial development. Just as increasing participation of developing countries in global financial governance is a prerequisite to effective global governance, and effective international security is one that takes at its starting point the different interests that face quite conflicting questions of security, an emphasis on sustainability also requires the means to include a diversity of interests in a legitimate political process.

Global climate change has recently been called the greatest market failure the world has ever seen.[29] If this failure is to be addressed, it will need considerable institutional capacity to do so. The goal of achieving this capacity, and the means to get there, will be undermined if countries of all stages of development are not directly involved in the shaping of solutions. Current policy development demonstrates this concern. The creation of international carbon markets are increasingly held out as an engine to encourage not only emission reductions but to encourage the technological innovation required to meet ambitious reduction targets.[30] While the ultimate effectiveness in mitigating carbon emissions through a global carbon market in this way remains to be seen, the management of such arrangements would require, like so many other global public policy solutions, a centralized source of funding, monitoring and assessment of priorities in order to meet objectives.

The short term path to effective environmental governance is to integrate a broader set of interests into existing multilateral governance capacity. The existing mandate of the Global Environmental Facility could be broadened in order to help coordinate and fund international environmental agreements and reflect developing country priorities. Complementary to this, the UN Environment Program could increase its status and responsibilities by becoming a specialized UN agency, with all the compulsory UN funding that this entails. The central challenge in the years ahead of compliance monitoring and enforcement could be facilitated through a formal international mechanism for settling environmental disputes through mediation and arbitration, potentially similar to the World Bank's investment dispute body.[31] Enhancing the capacities and responsibilities of the GEF and the UNEP in this way would be a step toward the more consolidated and formal institutional capacity of a World Environmental Organization as a longer term goal.

The challenges presented by the deep structural deficits in financial, security and environmental governance arrangements require not just analysis, but concrete action in the real world. Through the examination of these three domains, we have sought to show that the three principles of increased participation, the prioritization of social justice, and a focus on sustainability are not just ethical aims. They can be seen as core operating principles for effective global governance. Together, they can be utilized as animating principles around which substantive reform can be based through a process of coalition building and guiding struggle for change. A new global deal must be as ambitious as it is practical – the challenge is not to create an entirely new system of global governance, but to break the deadlock of mediocrity of policy solutions and inefficiency within the existing one in order to build on the progressive foundations of the postwar settlement upon which some of the achievements of international politics have been already based. The Figure below summarizes the proposals we are making. It does not present an all-or-nothing choice, but rather lays down a direction for change with clear points of orientation in the short and long run. The emphasis in Figure 1 is on elements of a global progressive deal; clearly, it is beyond the scope of the paper to discuss all the key institutional changes that might be required in the longer term.[32]

A coalition of political groupings could emerge to work with such an agenda, comprising European countries with strong liberal and social democratic traditions; liberal groups in the US polity which support multilateralism and the rule of law in international affairs; developing countries struggling for access and voice in global governance; non-governmental organizations campaigning for a more just, democratic and equitable world order; transnational social movements contesting the nature and form of contemporary globalization; elements of geopolitically resurgent states such as India, China and Russia; and, finally, those economic forces that desire a more stable and managed global economic order.

Europe is very well placed to make a special contribution to the cause of pushing such an agenda forward. As a home of both social democracy and an historical experiment in governance beyond the state, Europe has direct experience in considering the appropriate designs for more effective and accountable supra-state governance. It offers novel ways of thinking about governance beyond the state which encourage a (relatively) more democratic vision of global governance. Moreover, Europe is in a strategic position to build global constituencies for reform of the architecture and functioning of global governance. Through international dialogue, and through its strategic links with every region of the world, it has the potential to mobilize new cross-regional coalitions as a countervailing influence to those constituencies that oppose reform. The election of President Obama provides a unique opportunity for Europe to re-forge its ties to US based common policies of multilateralism, cooperation, and reform. Obama has committed himself to repairing the damage to America's image abroad created by the Bush Administrations. There is, therefore, a rare window of opportunity for the US and Europe to advance the cause of global institutional reform.

Whilst some of the interests which might coalesce around the efforts to enhance participation, social justice and sustainability at the global level would inevitably diverge in many ways, there is nevertheless an important and sizable overlapping sphere of concern among them for the strengthening and protection of the global commons. How far they can go to unite around the multiplicity of concrete issues that require urgent attention, and can overcome fierce opposition from well-entrenched geopolitical and economic interests, obviously remains to be seen. The stakes in such a process of struggle are high but are dwarfed by both the tremendous costs of inaction and the potential gains for creating a more inclusive, just, and sustainable world order.

Figure 1: Elements of a Progressive Deal on Global Institutional Change

Guiding Ethos

Global commons, a shared community of fate, the principle of equivalence circumscribed by the right to protection from serious harm.

Operational Principles

- Expanding participation of those seriously affected by global public policy decisions in the governance of international institutions.
- Integrating basic criteria of social justice as protection from serious harm – including from material depravation – into the international security agenda.
- Ensuring sustainability of both global environmental commons and the institutions to manage it.

Financial Governance

- Expand memberships of the Financial Stability Forum and Basel Committee
- Raise profile of UNCTAD's review of Monterrey Consensus
- Expand role for ECOSOC at multilateral meetings
- Public review and reform of the governance of the IMF and World Bank
- In the longer term, establishment of a World Financial Authority representing all regions of the world

Security

- Wider conception of human insecurity
- Re-linking the security and human rights agendas in international law
- Implementation of the UN's existing Millennium Development Goals
- Reforming the UN Security Council procedures to improve the authorization and management of humanitarian armed interventions
- Amend the current composition of the Security Council to extend representation to all regions of the world; broaden the remit of the Security Council or create an Economic and Social Council

Climate Change

- UN Environment Program becoming a specialized UN agency
- Expand mandate for the Global Environmental Facility
- Development of an international environmental dispute mechanism
- In the longer term, the consolidation of a World Environmental Organization which embeds participation of all countries in deliberation and decision-making procedures

Potential Coalition Partners Driving Change

The European Union, individual states with strong reform mandates, emerging power coalitions such as the BRICs, US Administration seeking new multilateral roles, global civil society organizations, reform groups within leading IGOs, and corporations seeking stable and sustainable world markets.

Endnotes

[1] David Held is the Graham Wallas Professor of Political Science at the London School of Economics. Kevin Young is LSE Fellow in Global Politics at the London School of Economics.

[2] See John-Francois Rischard, *High Noon* (New York: Basic Books, 2002)

[3] See David Held, *Global Covenant* (Cambridge: Polity, 2004).

[4] For a relatively concise overview and discussion, see David Held, "Reframing Global Governance: Apocalypse Soon or Reform!" *New Political Economy* Vol. 11, No. 2, June 2006. pp. 157-176.

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

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

[7] An example of this is the competitive bank deposit guarantees that swept across Europe in recent weeks.

[8] Bank for International Settlements, *BIS 77th Annual Report*, 24 June 2007.

[9] The Basel Committee is composed of participants from 13 member countries: Belgium, Canada, the Netherlands, Italy, France, Germany, Japan, Luxembourg, Spain, Sweden, Switzerland, the United States and the United Kingdom. While much can be said of the BCBS and its evolving structures of governance, suffice is to say that it does not have any formal developing participants. On critiques of the legitimacy and composition of the Basel Committee from a range of perspectives, see Howard Davies, "A Review of the Review", *Financial Markets, Institutions & Instruments* 14:5 (December 2005), pp. 247-252; Stephany Griffith-Jones Avinash Persaud, "The Pro-Cyclical Impact of Basel II on Emerging Markets and Its Political Economy", available at www.financialpolicy.org/financedev/ persaud.pdf; Geoffrey R. D. Underhill and Xiaoke Zhang, "Setting the Rules: Private Power, Political Underpinnings, and Legitimacy in Global Monetary and Financial Governance" *International Affairs,* 84:3 (2008), pp. 535-554.

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

[11] In this regard, over the past decade the Basel Committee has established some drafting and liason groups involving developing countries, as well as carrying out a (mostly) public consultation process with various interested stakeholders with respect to the development of the Revised Basel Accord. However both the core of deliberation and the formal decision-making process itself is restricted to Basel Committee members themselves.

[12] See Stanley Hoffmann, "America Goes Backward" *New York Review of Books* 50:10 (12 June 2003), pp. 74-80; Stanley Hoffmann "The Foreign Policy the US Needs" *New York Review of Books* 13:10 (August 2006), pp. 60-64.

[13] As John Ikenberry has pointed out, this doctrine has contradicted many of the core tenets of international politics and international agreements since 1945. See John Ikenberry, "America's Imperial Ambition", *Foreign Affairs*, 81:5 (2002), pp. 44-60.

[14] See Mary Kaldor, *New and Old Wars* (Cambridge: Polity Press, 1998).

[15] David Held and Mary Kaldor, "What Hope for the Future" Available at www.lse.ac.uk/depts/global/maryheld.htm ; Anthony Barnett, David Held, and Caspar Henderson, *Debating Globalization* (Cambridge: Polity, 2005)

[16] J. Solana, "The Future of Transnational Relations" *Progressive Politics* 2:2 (2003).

[17] Sir David A. King, "Climate Change Science: Adapt, Mitigate, or Ignore?", *Science*, Vol. 303 (January 2004), p. 177.

[18] For a discussion of the skeptics view, see David Held and Anthony McGrew, *Globalization / Anti-Globalization: Beyong the Great Divide* (Cambridge: Polity, 2007), pp. 64-72.

[19] See David Held, Anthony McGrew, David Goldblatt, and Jonathan Perraton, *Global Transformations: Politics, Economics and Culture* (Cambridge: Polity, 1999), pp 389-99.

[20] This was the case, for example, in the ambitious proposals put forward by the EU, Japan, Norway and Switzerland to include environmental issues in the Doha Ministerial Declaration during the Hong Kong round of WTO negotiations.

[21] Nicholas Stern and Laurence Tubiana, "A Progressive Global Deal on Climate Change" Paper Presentation, 5 April 2008, Available at http://documents.scribd.com/docs/mo91frl3sskk5a2q7i9.pdf

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

[23] See David Held, "Global Governance: Apocalypse Soon or Reform!" in David Held and Anthony McGrew (Eds.), *Globalization Theory: Approaches and Controversies* (Cambridge: Polity, 2007), pp. 252-3

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

[25] The Monterrey Consensus sought to ensure that if LDCs should have greater responsibility in framing the international regulations and institutions in which they participate and upon which their own national development strategies inevitably hinge upon. It sought to encourage greater participation of, and consultation with, LDCs in the decision-making of the major international financial institutions, notably including the BCBS. On the unfulfilled promise of Monterrey, see Jan Kregel, "From Monterrey to Basel: Who rules the banks?", *Social Watch*, 2006, pp. 26-28.

[26] Innumerable specific proposals have and will be floated. If the best among them is to have some success, they will need a forum to ensure consideration. In particular, the IMF could take on more roles as a global central bank by providing liquidity in an unencumbered way without the stress on conditionalities which have questionable usefulness. In this regard, as some have pointed out, the Short Term Liquidity Facility established recently is a step in the right direction, but needs to be broadened. As a more ambitious target, the IMF could be reformed such that its Special Drawing Rights are transformed into the basis for a global reserve currency. Again, effectiveness and accountability go hand in hand together. Such structural reforms at the IMF are incomprehensible if there is not an equivalent rebalancing of representation and robust mechanisms of accountability put in place – one which goes further than the recent reformation in voting shares. See Stephany Griffith-Jones, José Antonio Ocampo, and Sarah Burke-Rude, "Key Principles for Financial Reforms that G-20 Leaders Should Implement" *Initiative for Policy Dialogue Working Paper*, 11 November 2008. For an analysis of some of the consequences of, and potential for, governance reform at the IMF, see Eric Helleiner and Bessma Momani, "Slipping into Obscurity? Crisis and Reform at the IMF" *Centre for Internatinoal Governance Innovation Working Paper No. 16*, February 2007.

[27] On the relationship between participation and accountability in financial governance, see Randall Germain, "Globalising Accountability within the International Organization of Credit: Financial Governance and the Public Sphere" *Global Society*, 18:3 (July 2004), pp. 217-242.

[28] As Carmen Reinhart and Kenneth Rogoff have recently pointed out, the historical persistence of excessive leverage of financial institutions gives ground for "an international regulator with teeth" which could protect against

national political interests that would again push the large institutions to positions of excessive leverage. See Carmen Reinhart and Kenneth Rogoff, “Regulation Should be International” *Financial Times,* 18 November 2008.

[29] See Stern and Tubiana, “A Progressive Global Deal on Climate Change”, 2008.

[30] The Clean Development Mechanism under the Kyoto Protocol is one such example. It allows industrialized states with a greenhouse gas reduction commitment to invest in emission reduction projects in developing countries as an alternative to emission reductions in their own countries, thus allowing net global emmissions to be reduced at a lower cost. More recently, the Adaptation Fund was formalized at the United Nations Framework Convention on Climate Change at Poznań, which will finance adaptation projects in developing countries who are signatories to the Kyoto Protocol. The Fund will be financed from funds from the Clean Development mechanism activities, and will be administered through the Global Environmental Facility, with the World Bank acting as a trustee.

[31] See Nick Mabey, “Sustainability and Foreign Policy” in David Held and David Mepham (Eds.), *Progressive Foreign Policy: New Directions for the UK* (Cambridge: Polity Press, 2007), pp. 99-114.

[32] For a discussion of what these might include, see David Held, *Global Covenant*, 2004; Held and McGrew, *Globalization / Anti-Globalization,* 2007.

GLOBALIZATION

by
Danny Quah, Economics Department LSE
January 2009

1 INTRODUCTION

The term “globalization” has survived its first significant sell-by date in modern times. Globalization continues to attract policy attention and debate at the very highest levels.

This is appropriate and right. Together with just a handful of others—economic growth and inequality, financial crisis, climate change—with all of which it remains inextricably intertwined, only globalization among economic phenomena has both effects and causes observable from outer space. Its impact on the welfare of humanity is therefore singular. This is even before one considers the sweeping changes in culture and politics that ever greater global integration both requires and engenders.

This note cannot hope to cover the massive modern body of thinking that surrounds globalization. Instead, what it seeks to do is two-fold: one, flag, with the benefit of hindsight, some of the key background points that any continuing discussion of globalization needs to keep in mind; and two, conjecture where the most likely contentious issues in the near future might be.

To keep within space constraints, careful and exhaustive discussion of, say, empirical evidence is omitted. Instead, just the largest salient facts are provided where needed. A critical bibliography concludes the note.

2 THE MECHANICS

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

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

Globalization, therefore, most obviously comprises the shipping across countries of massive quantities of steel, aluminum, DVD players, bananas, textiles, coal, and grain. But globalization is also the offshoring via Internet of insurance claims processing, Powerpoint deck preparation, secondary school mathematics tutoring, and back office computer functions. It comprises foreign direct investment, foreign worker employment (for which total global repatriations already match in value foreign direct investment), and portfolio investment. And, not least, globalization comprises the value encoded in bitstrings of 0s and 1s coursing across Internet and other media pathways disseminating advertising, knowledge, ideas, and invention across the world.

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

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

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

3 THE IMPLICATIONS: COSTS AND BENEFITS

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

Globalization too then obviously comes with costs and benefits. The global economic system should continue to embrace globalization if the benefits outweigh the costs, and not otherwise.

The largest potential economic benefits can be reduced to very simple terms: raised economic growth and improved standards of living. But these are no trivial gains. From them, under normal circumstances, flow increased life expectancy and the reduction of disease, hunger, and poverty.

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

The greatest potential economic costs are three: increased income inequality; increased economic and financial instability; increased climate and environmental degradation.

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

3.1 INCOME INEQUALITY

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

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

If similar figures and trends manifest across developed countries other than the US, then the inequality side of the globalization debate has a well-defined set of parameters to it where reasonable observers might well have to agree to disagree.

But extend this comparison to a global scale, and the picture changes. Between 1981 and 2005 China brought 627 **million** people out of extreme $1/day poverty, even as inequality there rose from a Gini index of 0.28 to 0.50. That experience shows that a period of intensifying globalization can, for initially poor countries, improve the lot of the very poorest in society even as measured inequality rises from just macroeconomic growth, i.e., the increase in average incomes.

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

3.2 FINANCIAL AND ECONOMIC INSTABILITY

In the midst of perhaps the world's most serious financial and economic crisis since the Great Depression, it can be difficult to maintain distance and remember the good things that financial liberalization and globalization can engender.

Financial markets continue to be the single most widely-used way historically available to channel resources from savers to investors, to facilitate innovation and economic growth that in turn has raised the income of humanity 50-fold in the last 200 years.

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

In all cases, however, it is the excesses of the banking sector that first created the conditions for crisis and then later unwound to bring about collapse. National financial crises can occur even without the intrusion of globalization. Unquestionably, however, cross-country financial contagion and trade spillover aggregate demand impacts can potentially spread such crises across borders, and it is a subtle calculation to determine the costs and benefits here.

3.3 CLIMATE AND ENVIRONMENTAL CHANGE

Global climate change from economic activity—the burning of fossil fuels—is now as near to scientific fact as almost anything can be in the study of economics. Its connection to globalization is not perhaps as direct as, say, the cross-country spread of financial crises. On the other hand, its impact on human welfare is likely several orders of magnitude more pronounced and enduring. At the same time the international tensions that arise, and any useful policy proposals for ameliorating its effects are necessarily global and bring to bear all the same issues in every debate on globalization.

There is room here to put the matter only in the starkest simplest terms. The accumulation of greenhouse gas emission in the world's atmosphere has, historically, been due primarily to those countries now already developed. The greatest increments to that accumulation, however, are presently due to those countries such as China that are rapidly developing and raising their income levels. Schemes to stabilize greenhouse gas concentration in the atmosphere to prevent further dangerous disruption of the world's climate will succeed only with an agreement that allows both developed and emerging economies to arrive at a cooperate solution.

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

4 CONCLUSION

This note has outlined in the briefest terms one view on the current state of globalization in the world economy. It points to three large issues, surrounding which most policy concerns can be seen to derive. The three are global inequality; global financial and economic stability; and global climate change.

The quantification of costs and benefits on these three dimensions, and subsequent informed policy debate will usefully and significantly drive forwards our understanding of globalization.

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“How can we regulate capitalism ?”

Howard Davies, Director, London School of Economics and Political Science.

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

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

The Crisis and its Causes

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

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

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

Why was liquidity so loose? That remains highly disputed territory. Some argue that the principal failure was that the monetary policies failed to restrain liquidity growth, what one commentator has called “the great failure of central banking” (Reference 2). Others argue that interest rate policy was not obviously too lax, but that regulators failed to require banks, in particular, to retain adequate reserves in the upturn, to protect them against losses in the downturn. In other words, regulatory policy was pro – rather than counter cyclical.

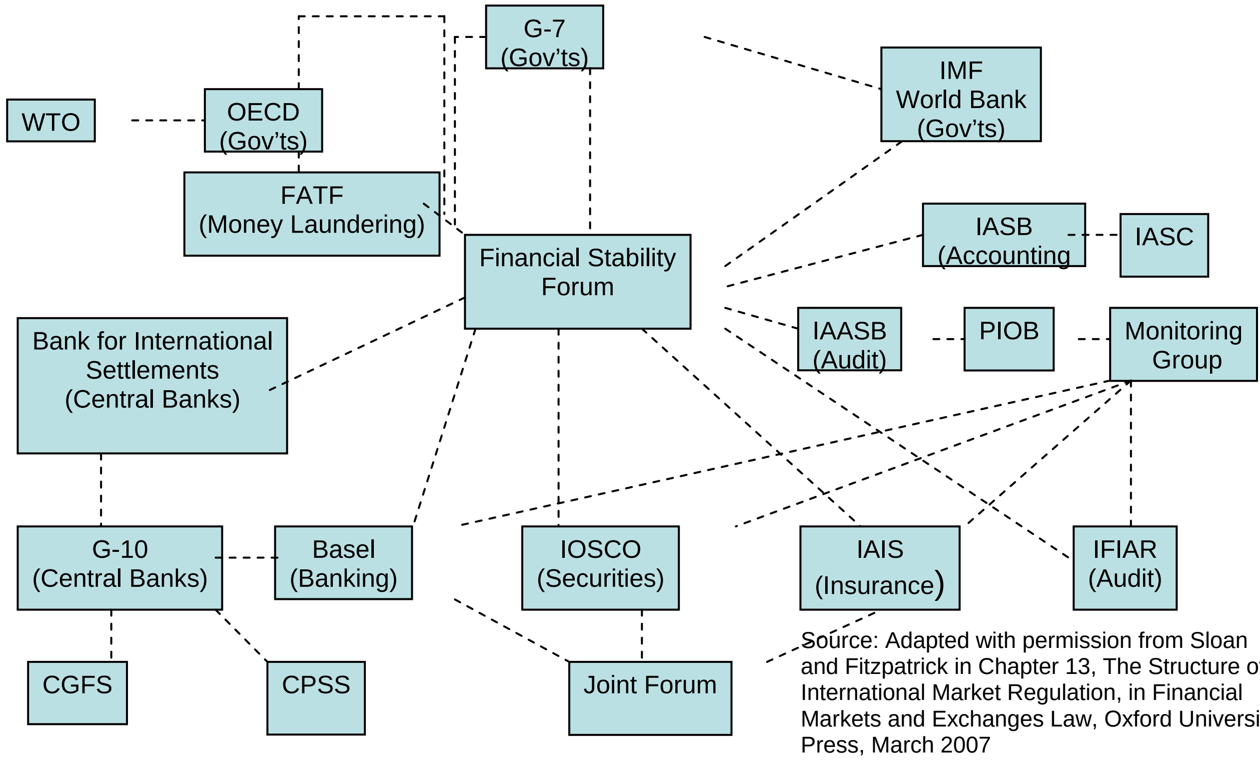
A further strand of analysis maintains that the underlying cause can be found in the so-called "global imbalances". Some Western economies, notably those in Anglo-Saxon countries, were over-consuming. In both the US and the UK household debt as a percentage of GDP rose to previously unheard of levels,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

International Financial Regulation

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

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

Global Committee Structure - A Regulator's View



Source: Adapted with permission from Sloan and Fitzpatrick in Chapter 13, The Structure of International Market Regulation, in Financial Markets and Exchanges Law, Oxford University Press, March 2007

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

The roles of the international financial institutions, the IMF and the World Bank, in this structure are also somewhat unclear. The principal functions of the IMF and the World Bank are to monitor compliance with international codes and standards, on the one hand, and to assist countries to meet those standards on the other. In addition, the IMF in particular is charged with monitoring global financial stability. The BIS performs a similar function in parallel. Both of them, in different ways, produced warnings about global imbalances and financial risk taking in the years leading up to the "explosion" in the summer of 2007. But those warnings were not hard wired into the regulatory system, and produced no concrete consequences in the form of tighter capital regulation. A good description of the pre-crisis analyses can be found in the Annual Reports of the Bank for International Settlements in 2007 and 2008 (Reference 4).

These weaknesses in the regulatory architecture have now been well understood by governments across the world. They were at the heart of the agenda for the G20 Summit in November 2008 in Washington. The fact that the Summit was convened on a G20 basis pointed to another problem: the unrepresentative nature of the bodies regulating the international financial system, whose composition reflected the financial world as it used to be, not as it now is. One early decision by that Summit was that the key institutions and committees must be re-balanced to bring the new financial powers into the core decision making processes. The Summit also set in train a number of work streams on detailed regulatory issues which will produce recommendations in time for the second G20 Financial Summit in London in April 2009. (Reference 5).

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

Key Issues to Address

1. The role of markets

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

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

2. The Future Role of the State

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

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

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

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

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

3. Balancing Legitimacy and Efficiency

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

4. The Global/National Balance

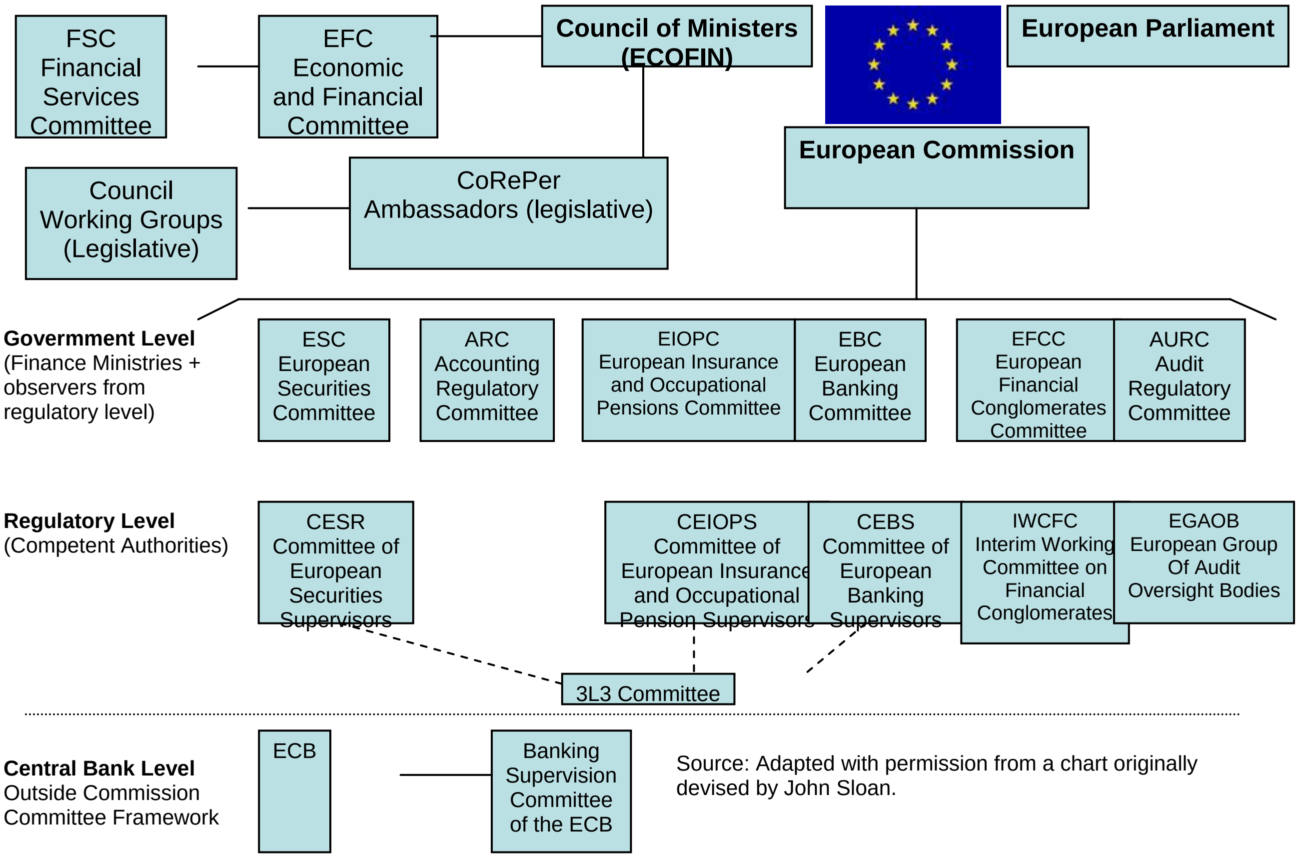
Some have argued that repeated malfunctions in the international financial system point to the need for a global regulator, perhaps a world financial authority (Reference 10). So far nation states have not been prepared to cede authority over their financial systems to a global body, however governed.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

5. How Should the Key Roles of International Regulation be Distributed Among the International Financial Institutions?

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

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

European Committee Structure



Source: Adapted with permission from a chart originally devised by John Sloan.

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

6. How "Tough" should regulation become?

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

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

7. The Borders of Regulation

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

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

Conclusion

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

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