The Public Good versus Private Interests and the Global Financial and Monetary System

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Introduction

The public domain, the commonweal, public interest, public goods, national interest - busybodies through the ages have tried to tell us as individuals what is good for us. Often “we” resisted, sometimes calling into question the whole notion of a wider collective interest beyond the aggregation of individual preferences. In extreme situations zealous authorities have compelled individuals to fit, for better or for worse, into predetermined notions of the public good whatever the preferences of individuals. These attempts usually ended in failure after much unpleasantness, the latest example being the collapse of the Soviet Bloc and end of the Cold War. The social engineering capabilities of markets are proving rather more effective instruments of change as some of the transformations known as “globalization” would indicate. Yet because of the emphasis of free market advocates on individual choice, the element of compulsion and the differential power of private actors in a market setting often remains obscured.*

Yet the controversy surrounding the relationship between the interests of the collectivity and the narrow interests of private individuals or corporate entities keeps coming back across a range of political cultures, whatever the nature of the political regime in place at a given moment. This is delicate ground to tread, the territory of the

most vexing but fundamental questions for humankind. Freedom is indeed one of the great causes of all time and, perhaps as a result, is poorly understood by most.

Yet, what better place to start than with the much misunderstood Adam Smith, who so long ago sketched out the problematic relationship between our selfish pursuit of individual interest, in particular private material gain, and the wider interests of "the publick" as a whole.[1] How can we achieve collectively satisfactory outcomes when most of us are incapable of rising above our own individual pursuits and selfishness?

Public Good vs. Private Interests

Somehow in all societies we know a sense of public good emerges, socially constructed through alchemy few of us would claim entirely to understand. Yet the notion of the public good emerges in different forms in different settings, underpinned by often contrasting notions of the public interest, embedded in the complex fabric of the political economy. It is tied up with the ways in which we sustain ourselves and the social structures which correspond to this. As well as with the types of institutions and patterns of authority we establish to this end and to the objective of governance of our wider complexity and with the ideas and contestations which we employ both to generate and justify these wider patterns of governance.

In his work on political economy, Smith was, of course, most concerned with a concept of the public good which contrasted with the private monopoly privileges and

rent-seeking behaviour of the sovereign and his cronies, or others in similar positions of power. Nonetheless, he was acutely aware of the ways in which any class of society (yes, even capitalists) could constitute a clique similar to that of the King and his friends and would exploit its position to protect its narrow interests and thus damage the public good:

The sneaking arts of underling tradesmen are thus erected into political maxims for the conduct of a great empire. For it is the most underling tradesmen only who make it a rule to employ chiefly their own customers.[2]

The market *could* be made to work, but the whole problem is how to prevent any powerful constituency from abusing its position to impose a private version of the public good on the rest of us (Skinner 1970: 79-82). In particular, the pursuit of private gain would only under certain conditions be commensurate with the public good: if sufficient competition were maintained to prevent particularistic interests from becoming rent-seeking oligopolies or worse. Preventing the merchant classes from grabbing hold of the public policy agenda and imposing their own interest to "widen the market and narrow the competition" (Smith 1937 [1776]: 250) is an ongoing struggle in this global era of ours. Smith's prescience in this regard deserves considerable attention as we consider the nature of the public domain in a global market society fragmented by multiple state jurisdictions.

The Argument

This chapter seeks to discuss the case of the global monetary and financial system in relation to the theme of the "public domain" as developed in this volume. This notion of the public domain as a "shared space" where government, market, and civil society meet is useful for our understanding of the global monetary and financial order in this era of transnational market integration. The chapter starts with the observation that few elements of governance are more crucial to the public interest, under whatever definition, than a functioning and stable monetary and financial system. While precise definitions of what is 'functioning and stable' may differ over time and may depend on one's perspective or interests, historically, financial and monetary crises are so tied up with calamity in human affairs that it is scarcely worth rehearsing the point (Kindleberger 1982 and 1989; Galbraith 1995). The twentieth century provides sufficient grim examples in this regard, starting from the end of the First World War. Since this element of the political economy is so important, this chapter poses the question: where should we situate the monetary and financial order in relation to the public versus the private? It is argued that the monetary and financial order is so vital that it should be placed firmly in the public domain, especially in the context of democratic political systems.

The transformation of the post-war financial system from a global order segmented on nationally-regulated lines, with tight controls on the short-term movements of capital, to a more market-oriented and globally integrated system characterised by a high degree of capital mobility, has involved a corresponding transformation in the notions of the public interest which underpin the operation of the

monetary and financial system. These changes are bound to have an impact on any discussion of the public domain in which one might engage. Private market actors and pressures now dominate the making of national economic policies as well as regulatory and supervisory policy in the financial sector. The central purpose of the chapter is therefore to examine *how the process of global financial integration and structural change has affected the changing balance of public authority versus private market power and interests* in relation to public policy-making in the domain of the monetary and financial system.

The principal argument is that the more market-oriented and transnational financial order which emerged in the past three decades has crucially altered the nature of public policy objectives and the way in which the "public interest" and therefore the objectives of state policies are defined, with a corresponding impact on the way we conceptualise the public good. As regulatory and supervisory tasks have been rendered more complex and competing national jurisdictions are increasingly unable to cope with the transnational nature of market structures, traditional lines of democratic accountability and political legitimacy have been placed in question, relative to the first decades of the post-war period(Underhill 1995, 1997b). Sometimes this incapacity of national governments to formulate economic and social policies in line with the preferences expressed in national democratic processes was an act of state "self-bondage" to resist the inflationary pressures of the democratic process. Sometimes this was in response to powerful organised coalitions of interests promoting more liberal policies. The monetary and financial order is in danger of being placed

beyond the shared space of the public, and into the exclusive domain of private market actors.

The Public Domain and the Monetary and Financial System

Smith long ago laid out many of the important parameters of this difficult terrain. If it is idealistic to attempt to determine the precise point at which individual interests and the public interest coincides, we must at least make choices about the outcomes we prefer and the elements of governance which are most likely to get us there. In this sense, the distinction between the public domain and public interest on the one hand, and the legitimate realm of narrow private interests in the market on the other, has never been and can never be unambiguous. A complex mix of private interests can be observed in the making of public policy. One may at best conclude that a satisfactory balance of public and particularistic interests is vital to the successful and legitimate functioning of a market economy in a democratic context. Satisfactory to the (rather indeterminate) imperatives of the national political economy in question. The dominance of systems of governance by narrow, market-based private interests can give rise to problems of legitimacy for particular democratic regimes. Given the nature of systemic risk, if financial sectors and regulatory and supervisory processes become unduly dominated by private interests writing the rules for their own convenience and profit, we risk not only the legitimacy deficit but instability and crisis as well.

Historically, financial institutions and market participants (unfortunately for my

argument, this sometimes includes governments) have consistently shown themselves incapable of restraint in the face of temptations provided by a rising market in highly risky products, from real property to derivatives to LDC debt. The watchful eye of an external and objective authority which itself does not stand to gain or lose from specific market conditions or transaction has in many circumstances provided the necessary restraint on the herd. Admittedly, the existence of such an agency is in itself no guarantee (supervisors *can* get it wrong). Yet the disastrous consequences of mistakes in the financial sector for confidence in the monetary system make such an agency, as representative of the public domain, an imperative. These consequences can include economic collapse or at least deep recession, increased distributional strife and economic hardship, threats to democratic stability, attempts by states to externalise the consequences in ways which negatively affect other national interests, and sometimes war.

So the notion of the public domain and corresponding interpretations of the public good has something to do with the need of political systems for legitimacy in terms of economic opportunity, institutions and modes of governance, and distributional outcome. A workable system can come in many different packages. Most are worked out painfully over time and are under constant revision, and few approach anything one might regard as ideal.

The rise of democracy has significantly shifted the goal posts in a positive fashion. Successful democracy rests on the practical notion that the interests of individual or private entities cannot adequately be provided for in the absence of some

definition of a wider community or collective good, and that for this to obtain individuals and associations should participate however imperfectly in the definition of this public interest. The outcome, if considered legitimate on a roughly majoritarian principle, is not necessarily to be confused with justice but hopefully is closer to it than the more arbitrary exercise of authority.

But the very imperfection of such arrangements provides a considerable space for leadership and debate on the nature of the public interest and the legitimate extent of the public domain as opposed to private individual or corporate prerogatives. In this space, there is an ongoing danger that the more structurally powerful and politically resourceful are successful at defining and indeed capturing the definition of the public interest through the policy process, even under conditions of democracy. This situation is well know in trade policy, especially where trade protection is concerned.[3] Though states can never separate themselves out from the society and market system in which they are embedded, they can and do struggle (and should probably struggle harder) to provide public policy frameworks which serve a relatively objective function amidst the morass of competing private claims.

Indeed, some form of political authority has always been present in economic systems based on market principles, and this includes the monetary and financial system. It takes on different forms, ranging from self-regulatory orders based on compromise within the community of firms and their associations, to state-based systems which imagine themselves free of particularistic influence. Basically, if the state does not rig the market, then private interests will, and sometimes do so on

perfectly sensible terms under the circumstances. Without the provision of public goods (and indeed much more besides), markets do not function. There can be considerable argument, even among market actors of different types and with correspondingly different interests, about what these public goods and the normative principles or policy objectives behind them should consist. One cannot presume to escape these normative dimensions. Defining the extent of the public domain and the nature of the public interest entails defining *what kind of society we want*.

The monetary and financial order adopted will be central to achieving any goals once defined because it is so fundamental to the way markets operate and to the distributional outcome. Under conditions of transnational integration, the monetary and financial system (and its associated national entities) will be structured largely along the lines of the way in which the provision of credit is created, allocated, and regulated in dominant financial centres, or the 'international organization of credit' as Germain refers to it (Germain 1996: 29). Who has access to credit, how it is regulated, and how stability is maintained will exert a primordial influence on the nature and characteristics of a particular economic system (Underhill 1999). But the policy process and practices which shape the monetary order as the basic infrastructure of the market system are far from neutral.[4] Supervision and regulation of the credit allocation process have costs for the firms in the market and countries in the system, and the costs imposed will vary in relative terms depending on the nature of a firm's business, the scale of its operations, and the extent to which it operates across legal jurisdictions.

Most long-run successful monetary orders have developed a clear sense of the

public interest to maintain some version of stability, and this concept of public good is usually institutionalized in a central establishment to ensure systemic stability and risk management. Such an institution, like the Amsterdam Exchange Bank (the *Wisselbank*) of the 17th-18th centuries or contemporary national central banks in dominant financial systems, must have sufficient power in the markets and recognised political authority/legitimacy to provide rules for the market and standards in terms of conduct, to say nothing of lender of last resort/refinancing facilities in the inevitable times of trouble.

The nature of all these provisions varies enormously with respect to the extent of direct state involvement, the level of domestic versus transnational transactions, bank-based versus securities market credit allocation, the relationship of the financial sector to the real economy, and system of corporate governance.[5] 'What kind of monetary and financial order do we want, and to serve what function/purpose in the larger picture of the ongoing economic development process?' These are the questions we should be answering. Is it primarily for the finance of state-initiated projects, from public investments to military adventures? Is it for the achievement of rapid catch-up industrial development? Is it a gigantic inter-generational borrowing scam (as some methods of state pension finance or the expansion of government debt appear to indicate), compromising the future of our children? Is it aimed at providing long-term investment capital for the maintenance of a competitive export-oriented manufacturing sector? What sort of outcome in terms of distribution do we want, as savings and investment will affect growth and productivity prospects and therefore wages and their

distribution across the economy?

Much discussion of the global monetary and financial system ignores these basic questions and facts about the way it is regulated, supervised, and structured. Most accounts assume that the "public good" is given as a *deus ex machina*. That it is self-evident what the public interest consists of with regards to the monetary and financial domain; reasonable control of inflationary pressures and basic systemic stability. Yet over the course of history and in the contemporary period, we see very different financial systems in existence, each underpinned by contrasting sets of normative values and differing conceptions of the public good or interest. The concepts of basic monetary and financial stability admit of enormous discretion in terms of definition and implementation in constantly changing circumstances, and this discretion is usually exercised in relation to the material interest of those in a position to do so. Furthermore, and more worrisomely, state agencies often lack the expert knowledge of fast-moving market environments which accrues to the market players. Indeed senior management often lacks knowledge of what their dealers are up to and thus the shared expertise. Sadly all this puts state officials in a dependent position.[6]

Monetary and Financial Order and the Public Interest

The key question is whether the monetary and financial system should be part of the pubic "domain" or whether the public good would be better served should it be thought of as a private market affair. However one answers this question, I doubt very

much (as per the discussion in section one and the Introduction to this article) that a clear and precise claim to place it purely in the hands of public authorities or those of private market agents can be made. With very few exceptions among the sane, even ardent advocates of market-based monetary and financial governance admit to the need to provide public goods to avert market failure and help in the task of private risk management. Market authorities should insist on adequate levels of disclosure by firms to augment the provision of information, transparency in terms of price information, fraud prevention, and accounting and capital adequacy standards for prudential purposes. At the very least, while no firm enjoys the costs of a regulatory or supervisory burden, most will admit that they wish to know that their arm's length counterparties (perhaps on the other side of the world with the only contact being through a computer network) are sound business partners.[7] Authorities can also help by providing a clear lead in terms of macroeconomic policy demonstrating sensitivity to market expectations. These public goods could, of course, be provided in the main by market disciplines in terms of self-regulation, though many would argue that removing such decisions from private hands is more likely to lead to the objective, disinterested fulfilment of these essential policy functions. In short, there is little basis for the argument that monetary and financial system governance should be placed exclusively in the private market domain.

So what of the claim that it be placed in public hands? If one takes this literally, this surely implies a state-owned and planned monetary order organized around the public monopoly provision of intermediary services between savers and investors. To

employ understatement, the record of centrally-planned systems which did in fact organise themselves on this basis is rather poor. Perhaps they would have worked better had other sectors in the economy been opened to private provision and only the financial and monetary orders subject to public sector control. But I suspect that the queue for those signing up to such a proposal would be rather short. So there is little weight to the argument that the monetary and financial order is exclusively a public prerogative, at least through the mechanisms of state control and monopoly. We might be able to design a co-operative-based or mutual-society based financial system (credit unions, mutual trusts, building societies), and most national financial systems have some element of this, but these forms of micro-level organisation are today coming under increasing pressure.

Most existing national systems have a complex mix of the public and the private at work in terms of both market activity and the exercise of regulatory, supervisory, and monetary policy functions.[8] That these have evolved over time should provide us with a clue to answering the question posed at the outset of this section. The satisfactory functioning of the monetary underpinnings of the political economy is of interest to state, market, and the rest of us alike.In a democracy we are, in fact, all involved in each in one way or another. Because it is shared in this way, it can never be attributed exclusively to any of the three, each of which one might argue is 'private' in its own way, though state policy processes in a democratic context have the best claim to the provision of goods/assets in the public domain and to underwriting of its "public-ness."

If this is the case, then when we speak of the monetary and financial system or

order, in the overall sense, it is certainly part of the public domain. The public domain and the notion of the public good which stems from it are of interest to all. The fact that we so often tend to see public and private in opposition to each other relates to a conceptual flaw in our common understanding of markets. They are *not* a private domain, if Adam Smith is to be properly understood, but their successful functioning and the precise way in which they function are most imperatively *of interest to the general public* and will be intimately linked to our sense of community, morality, and what it is to be human (Heilbroner 1986: 1-11; Skinner 1970).

Market interactions are one of the important means through which we achieve public policy goals. State and market as a condominium should be seen as part of the wider pattern and institutions of governance, state and market as an integrated ensemble of governance, not as a tug-of war one with the other. Markets can and should be aimed at achieving the public good, not operating counter to it, and must be made to do so in a way appropriate to each historical and socio-political context. We should not identify the public good exclusively with what states do, nor the state exclusively with communitarian interests (especially given the capacity of private groups to appropriate the mantel of public legitimacy). The public good is necessarily bound up with our interests as private and corporate individuals.

To be more specific, the *transactions* of the monetary and financial system are largely private (though with a substantial state element, if for no other reason than that government debt issued by the treasury/central bank is usually the largest single chunk of the debt market). Yet the way the *system* operates as a whole makes it part of that

essential infrastructure of the political economy, of such overwhelming value to state, market, and the well-being of civil society, that it must be placed firmly *at the heart of the public domain*. Because this domain is essentially shared, what is needed is not a clear public-private distinction, *but a clear definition of the public good/public interest in relation to the specific policy issues, which touch on the monetary and financial order*. If the monetary and financial system is to be successfully integrated into the public domain, we need to construct a notion of the public good and to develop the means to achieve it in terms of policy. If one values innovation in the markets one should aim at it, if one values stability one should aim for it, if one wishes a mix of these or other normative values, then one should aim for it but be aware of the necessary precariousness of any compromise.

It is these versions of the public good or public interest, and the means to achieve them in the governance of the monetary and financial order, which vary so strikingly from one national political economy to another. To decide what sort of monetary and financial order is desirable (and note the inevitable normative content of the choice), democratic systems must make clear decisions about the functions they wish the system to serve, as discussed in section one. They must furthermore *have the necessary capacity in order to do so* or the monetary and financial order will consistently reside in the captive, private terrain of market actors, not the shared space of the public domain. We should also be mindful that the public good in terms of monetary and financial governance can be defined and achieved in a variety of ways, and that models can only with difficulty, if at all, be transported from one historical

context to another.

Thus, there will always be a tension between private market actor preference and the public good in terms of global finance and monetary management. There is likely to be, as a result, an ongoing sharing of responsibility for the system by both markets and state authorities, with substantial input from civil society. But the key point is that in a democracy the imperatives of political legitimacy are likely in the long run, to hold sway. If market liberalisation and transnationalisation run roughshod over delicate social and political compromises underpinning national political economies, liberal policies are likely to be abandoned.[9] Democratic choice can and should be exercised in the regulatory and supervisory policy processes which shape the system as well as in the domain of macro-economic policy-making. The trouble is that democratic choice seldom comes to bear in the contemporary context. Instead these policy issues are too often viewed as matters exclusively for technocratic competence, thus making a well-rounded definition of the public good difficult.

From Bretton Woods to the New Order

One occasion when democracies were able to challenge the historically institutionalised assumptions about the public good which were at work in the monetary and financial order was at the Bretton Woods conference in 1944 (Gardner 1981). The failures of the Gold Standard and *laissez-faire*, along with the acknowledged benefits of a more-or-less liberal market system, were held up to scrutiny and fundamental choices

were made. The Bretton Woods agreements sought to resolve the tension between pursuit of private gain and the realisation of public policy goals in a democratic context, definitively in favour of public control of the monetary and financial order. The aim of the Bretton Woods planners was to "drive the usurious money lenders from the temple of international finance."[10] Private financial markets were to be at the service of national economic development and policy goals, not to dominate them, the better to ensure that financial instability never again undermined the political legitimacy of emerging democratic countries or endangered international security as had been the case in the interwar period. Keynes also argued that state control of finance would also facilitate the maintenance of open trading relations.

The Bretton Woods compromise was greatly facilitated by the fact that most of the discussions were bilateral negotiations between the US and the UK. Others who were influential, such as the Canadian delegation, were also amongst the advanced market economies of their day. Thus the differences among the economies and national interests of the negotiating parties were not as great as they might have been had more, and more diverse, parties been involved.

Much has changed since Bretton Woods. Since then, regulatory change (often state-led), corporate innovation, and the altered environment within which competition takes place dramatically transformed the characteristics of the international monetary and financial system, particularly from the 1970s onwards. We now have a much more global financial system than the nationally-based order established in 1944 (Helleiner 1994; Cohen 1998). Developments such as the "securitisation" of banking enhanced

the importance of portfolio investment patterns, and the relatively short-term capital flows often associated with the development of such markets.

Impact on Public Policy

At the present time, there are serious issues of public policy at stake, and therefore these changes have affected the public interest, altering for whom and for what the monetary and financial order operates. In particular, the acceleration of short-term capital mobility has had a considerable impact on the efficacy of domestic monetary policies and exchange rate policies. The impact on government debt management is no less pronounced, and private investor funds have become vulnerable to increased market volatility and risk (though with potentially greater returns). At the same time, the traditional domestic regulatory and supervisory institutions overseeing financial market activities appear ill-adapted to a world of securitised banking markets and cross-border and cross-exchange trading in a growing variety of products.

Many public agencies traditionally served a financial system highly segmented according to specialised function and effectively cordoned by national political boundaries. The reshaping of domestic financial sectors through regulatory reform, corporate innovation, and the transnationalisation of markets has left traditional supervisors and regulators caught in a tide of international transactions beyond their effective capacity to monitor.

With national regulatory and supervisory institutions and systems under pressure, it seems rational to expect these agencies to seek to co-operate with their overseas equivalents, in order to increase the effectiveness of their policies and fulfil their respective legal mandates. However, the difficulties of co-operation in an international system of competing state jurisdictions are well known. This makes a co-operative definition of the "international" public good seriously problematic.

To complicate matters, it seems that state agencies often seek not just effective regulation and supervision, but also to improve market opportunities for national players and to enhance the attractiveness to investors of national financial markets. Thus, the potential for regulatory competition and indeed conflict is considerable. Secondly, co-operation is rendered problematic due to differences in domestic market structures and types of financial institutions, differences in national regulatory styles and institutional patterns, and different legal and accounting systems all used in defining the domain of the markets. Furthermore, in view of the securitisation phenomenon, while co-operation amongst central bankers goes back to the 19th century in some cases, international co-operation among national securities regulators is an altogether recent phenomenon with a few exceptions.

So many governments find themselves under significant external pressure in the making and implementation of monetary, exchange rate, and financial sector policy. Private market pressures and interests now dominate the making of national macroeconomic policies, as well as regulatory and supervisory policy in the financial sector.[11] The jurisdictions of governments and their regulatory agencies coincide less

and less with the domain of the very markets for which they are responsible. The rapid changes in the global banking and securities markets call into question the established institutional patterns of regulation and supervision in a fundamental way. Effective co-operative management across borders on matters such as systemic risk, investor/depositor protection and compensation, or clearing and settlement has required extensive alteration and mutual recognition of differing national practices. In short, situating the monetary and financial order at the heart of the public domain is increasingly difficult.

Defining the Public Good in a Global Context

As this discussion implies, these structural changes in the markets present a series of dilemmas and policy-making difficulties in the context of a democratic system which, one might argue, puts the functioning of the monetary and financial system at a variance with a sensible definition of the public good and due attention to nurturing the public domain. Some of these dilemmas are relatively well known so the discussion will focus on relating them to the changing conceptions of the public good which have accompanied the transformation in the structure of global monetary and financial space, and of the national systems which populate it.

Although states played a central role in the global integration of markets, policies have often borne a close relationship to the preferences of private market actors in dominant financial sectors, raising the spectre of regulatory capture as they

spread their “universal” practices throughout the world. An underlying assumption of the global market integration process was that the steady convergence of national systems would require a steady convergence of regulatory, supervisory, and macro-economic policies. As standards emerged, however, they often did not fit the underlying diversity of national systems, which remained hidden by the emergence of “global” space. The predicted wholesale convergence did not take place, yet the policies of emerging international regulatory institutions, in terms of either crisis management or supervisory practice, take into account this continuing diversity with understandable difficulty. Global integration is a growing and complex network of linkages among what remain fundamentally different financial systems designed to fulfill different roles in their respective national economies. Different financial systems will respond to uniform policies in different ways.

Policies must be sufficiently adaptable to suit a wide range of situations, and the objective of one policy for one global system, assuming this is ever seriously entertained, should be resisted. The pressures for policy convergence from global markets and from the dominant financial centres can undermine the sense that monetary and financial integration can work to the public good of, in particular, individual emerging market national economies. This new financial system is clearly more volatile than the earlier order, whatever its other merits might be.

If public policy does not accept that for some time there will remain considerable diversity underpinning the integration process, then global financial integration will continue to produce crises which are managed in a way which is inappropriate to many

of the national economies in the system. Co-operation may become strained, and may break down over time. Public policy must not operate on the assumption that the global public interest is met in serving only the interests of the dominant financial centres, which certainly sometimes forget the interests of the non-financial and public sector there as well. The governance of the monetary and financial order affects us all and belongs squarely in the public domain.

Change has also come for the corporate sector. Market segments of the wider financial services industry have become less and less distinct as a result of structural and institutional changes at the micro level, particularly ownership structures. Specialisation is still an important feature of financial market activities (Garten 1997), especially in company strategies where niche activities remain important, and in the labour market where specialised skills are necessary. Yet large banks and securities houses are now masters of vast financial conglomerates. This renders risk management, in this key ingredient of the public domain, complex and problematic. Regulatory and supervisory challenges in the industry reflect this development, and supervisors must monitor risk across several segments of market activity as well as across national jurisdictional boundaries. So must private sector risk managers, their task is greatly complicated too. The potential for spillover and contagion from one segment to another is commensurately enhanced, a situation which potentially puts the public interest at risk.

A key problem is that many national supervisory and regulatory authorities remain segmented along specialised institutional or federal lines, or both.On the other

hand, the UK, for example, has moved to the “one big regulator” approach, which makes consolidated supervision of conglomerate firms, in particular, more difficult. The counterpart to this development is that regulators and supervisors have sought to reinforce co-operation across jurisdictional and national boundaries, leading to bodies such as the Basle-based “Joint Forum”of banking, securities, and insurance supervisors. Such co-operation however remains inherently problematic, and certainly proceeds more slowly than the rapid restructuring occurring in industry, and supervisors from different jurisdiction’s find that traditional rules and procedures often impede optimal co-operative efforts. Authorities at national and international levels should attempt to accelerate and deepen efforts at co-operation, especially in the domain of supervision and crisis prevention. Yet this co-operation must allow for a diversity of national financial systems and of definitions of the public good.

In this sense, policies should not be developed in the expectation of wholesale convergence of national systems, nor of the emergence of a uniformly integrated global financial system. Global financial architecture will still need to be differentiated according to where and for whom it is built. Another question should also be confronted, that of the balance between *regulation* aimed at containing the risks taken by firms, and the *supervision* of the practices of firms for safety and soundness.

In recent years, the balance has shifted strongly in favour of a removal of restrictive, “anti-competitive” regulation developed to contain market excesses and toward (at least where best practice is followed) the strengthening and adaptation of supervision to permit competitive market pressures to act as an instrument of risk

management. Public authorities across a range of countries felt it was no longer their task to restrict what firms do in the interest of prudential behaviour by financial institutions, this being left to the market. We should at least reflect on whether this is not overly convenient to the firms themselves, leaving too much public responsibility for safety and soundness in their self-interested private hands. States, after all, took over these responsibilities in the post-depression period after the comprehensive failure of (albeit *seriously* underdeveloped) market-based and self-regulatory mechanisms.

Private Interests and the Regulatory Policy Process

As outlined above, regulatory change and rapidly adapting corporate strategies together have led to a less segmented and more market-oriented financial system than in the earlier postwar period. Tremendous growth in short-term capital flows and portfolio investments in sometimes complex and indeed exotic products have greatly complicated the problems of the international monetary system. States struggle to realise their macroeconomic policy aims in monetary and exchange rate policy. Major policy commitments of democratically elected governments have often been thrown into disarray as a result of the aggregate behaviour of global investors.

While this has been known for some time, less well known is the way these developments came about. The regulatory policy process was dominated by the private interests of major firms, which found ready respondents in state and central bank officials who shared their view in many respects. The regulatory policy changes

which led to such considerable structural market changes were most often taken in isolation from any systematic consideration of the consequences for monetary and exchange rate policies - the evidence is very strong on this point. Regulatory policy change was perceived as necessary in order to enhance the efficiency of financial markets, and decisions were taken in close co-operation with the major players in domestic financial markets, often including foreign players. The difficulties which these structural market changes would present for the realisation of important policy commitments of democratic regimes (particularly in emerging market countries, which were often fragile, emerging democracies as well) were given little consideration. There was certainly little consideration of the problems of political legitimacy, which market preferences, in terms of macro policies, might pose for domestic political regimes. If there was simultaneous consideration of regulatory and macro policies, often the surreptitious goal was to de-politicise important aspects of macroeconomic policymaking, sometimes enhanced by creating or strengthening an independent central bank. This formula worked as long as stability was ensured, but when adverse investor reactions to perceived policy errors led to crisis and instability, it was discovered that major economic policy issues remained stubbornly political despite the best efforts of technocratic configurations. The policies of international financial institutions reinforced the difficulty in many cases.

In the retreating shadow of the Asian Crisis this dilemma is felt acutely. Nonetheless there is a genuine loss of direction in policy terms. States and their agencies, as well as firms, are still learning about the changed environment. They

realise they cannot go back, and that the new market structure greatly circumscribes options. There is considerable questioning in official and even in private circles of the so-called “Washington consensus,” but new approaches to management of the global financial system are still lacking. In this sense, the public good is lacking definition and needs urgently to be clarified by official and private authorities alike. The risk is that, as the crisis fades in the memory of, at least, the dominant financial centres, complacency becomes a palliative for the genuine bewilderment felt.

Furthermore, efforts to enhance global supervisory and regulatory co-operation, crucial for global risk management, have a perverse effect. By reducing risk and transaction costs through the harmonisation and co-ordination of standards, they further accelerate structural changes in the markets, with a commensurate impact on regulatory and supervisory policy dilemmas and on the making of macroeconomic policy. In the new market environment, few regulators or supervisors believe that their policies should guide or limit the development of the market. One must ask whether this accelerating pace of change permits adequate time for adjustment and for political systems to cope.

In supervision and risk management, in the new environment, the principal result has been the emergence of “market-based” approaches to supervision, wherein firms are responsible for risk management through complex mathematical models implemented under the approval of supervisory agencies. The problem becomes, *who* defines the criteria for the regulation and supervision of the markets, and in what consists the public interest?

Crucial information and expertise for the process remains the proprietary domain of firms which supervisors admit they cannot match. In a highly competitive environment there is also an intense need for firms to remain relatively free, in terms of product innovation and corporate strategy. Level playing field concerns abound. This relative disarmament of public authorities carries with it the very real risk that private market interests increasingly define supervisory criteria. This would mean that this crucial aspect of public policy, the safety and stability of the financial system, is dominated by the preferences of those very private market agents who profit from it most. Public authorities are potentially reduced to crisis management and (costly) lender-of-last-resort functions. The implications for moral hazards in crisis management should not go unnoticed. The mix of public and private is always a problem in any regulatory context, but the marketisation of the global financial system brings this dilemma sharply into focus.

An example of this dilemma may have been provided by the recent draft proposals by the Basle Committee revising the 1988 capital adequacy accord (Basle Committee 1999).[12] Most of the draft is to be welcomed with enthusiasm as it renders more discriminating the blunt instrument of the original 1988 standards. Some attention needed to be paid to the relative risks of different types of assets in banks' portfolios - we all know the difference between a Treasury Bill and a junk bond but there is much in between. It is also to be applauded that interest rate and other types of risks are to be brought under the umbrella. Encouraging high corporate disclosure standards, a responsiveness to financial innovation, and making capital standards more risk

sensitive, are all positive developments.

By contrast, one is more sceptical about the proposal that supervisory authorities increase their reliance on market discipline as a tool of the trade. Market disciplines have taken banks into many overly risky ventures in the past, such as the LDC debt crisis to which the original Basle Accord was in part a response. One might also challenge the proposal to make increased use of private rating agencies in supervision. In the developed country markets where information and rating agency expertise is fairly well established this might be fine, but elsewhere healthy scepticism is perhaps in order. We should bear in mind that some experts have argued that the information available, well prior to the Mexican and Asian crises, was sufficient to warn prudent investors that capital inflows should slow down, but little heed was taken of this by industry analysts (see debate in Teunissen 1996). Where were the rating agencies in the months leading to the crises, and what effects did they have on investor expectations? At the least one can observe that the retreat by investors was far from orderly.

Finally, the proposal to allow “sophisticated banks” (presumably the discredited Bankers Trust was one of these, along with the bankers to LTCM or the underwriters of massive Russian bond issues) to use an internal ratings-based approach should at least give rise to further consideration, as no doubt will be the case in the consultation process set in motion by the Basle Committee. Encouraging sophisticated internal management controls is definitely positive, but increasing *reliance* upon them by *supervisory* authorities is of less merit. There is always a potential conflict of interest in

the firm's internal assessment process, with a temptation to stretch standards when the institution is in a tight corner or quite simply making pots of money.[13] The proposals risk putting supervisors at too far a remove from the actual business of supervision, with the potential move to add "self-supervision" to the already common practice of self-regulation. Much will depend on how this aspect of the proposals is implemented in the final analysis, including the vetting and monitoring of internal control mechanisms by supervisors themselves. But to what extent once again should private corporate power be in on defining the public good in this vital policy domain?

National Financial Reform Programmes

The answer in many cases is that with reform of national financial sector regulation, supervision, and the practices of national firms, the better to cope with global integration. Yet the financial systems of most countries are the result of long incubation, and historical differences from one to another remain considerable, as do differences in regulatory and supervisory policy. Despite these differences, the assumed model of most international regulatory or supervisory co-operation is that of an open (transnational) capital market-based financial system. In a number of cases, national and international agencies have advocated policy changes which should, especially following the Asian crisis and subsequent ripple effects, clearly be questioned. Open capital accounts were grafted onto financial systems which historically operated on a closed and "insider" basis. External pressure usually from

creditor governments and international financial agencies to open the capital account was often underpinned by intense lobbying pressure from private interests which wanted access to these markets, as clearly revealed in the case of the WTO financial services agreement process concluded in 1997 (WTO 1998).

The ambitions of governments to appear at the forefront of the liberalisation movement and to join the western 'club', as in the Korean drive for OECD membership. resulted in the worst of worlds. Domestic sectors were not reformed but capital accounts opened. This compromise satisfied a range of external interests, and gave local institutions easier access to global markets and foreign currency dealings.[14] It was the path of least political resistance, and this was a crucial factor behind the ensuing global financial instability.

To add to the problem, it was often forgotten that liberalisation requires systematic restructuring of regulatory and supervisory processes as well, and this aspect of financial market development has received too little attention in the face of liberalisation often undertaken under external pressure (Wyplosz 1999: 184-5). Patience and long-term planning are required if liberalisation and transnationalisation are to bring positive results. One often forgets that the liberalisation of western financial systems took several decades following World War II, and creditor countries appear unwilling to grant emerging market economies the same luxury. Liberalisation is likely to become greatly tarnished as a policy goal if it is not implemented cautiously.

Private Interests and Good Governance

Let us once again remind ourselves that the financial services industry within many countries constitutes an ongoing lobby to further liberalise and integrate domestic systems with the global. As mentioned, developed country pressure to change the nature of the financial systems of emerging market economies intensifies this trend. Research has little difficulty in establishing that powerful private interests were the principal interlocutors of official agencies in the development and reform of regulatory and supervisory policy. Of course, one would expect them to be involved but to be balanced by other actors in the policy process. Too often this is not the case. These private interests are simultaneously the object of regulation/supervision *and* chief counsellors in the formulation of official policy. In such a situation it is increasingly difficult to develop a notion of public interest or public good at the level of national or international regulatory institutions in global markets, at least beyond the obvious and very general goal of preventing a systemic crisis in global finance. There is an ongoing conflict across national financial sectors and among regulators and supervisors concerning the norms and values which should underpin the global financial system. Domestic regulators are still most responsive to their historic practices and to perceived domestic constituencies. They may champion the interests of national firms or valued domestic standards of regulation, thus impairing the effectiveness of co-operation. The objectives of participating domestic agencies are therefore coloured by their closeness to their market constituents in a situation which often approximates “capture.”

Given the ongoing enhancement of private agency and international institutions in global governance, there is also a need to think systematically about the problem of accountability in democratic political systems. This problem affects the development process as well, at the very least because the problem of financial instability is most acute for vulnerable, emerging market economies undertaking fragile democratisation processes at the same time. If we can historically associate stable democracies with the relative absence of conflict and war, the political legitimacy issue needs to be taken more seriously in the policy process.

There is a tendency in a great deal of the economics literature and resulting policy advice generated at the very core of governments and IFIs to treat these political realities as unnecessary intrusions into the ideal of governance through market processes. If states and markets are indeed (as I have argued) integrated ensembles of governance, this attitude is a serious obstacle to addressing the problem of "good governance" in the global political economy. Local norms and cultures cannot be wished away in this regard, especially if democratic choice is to have meaning in any ongoing fashion. Democratic societies will and *should* continue to differ in terms of policy mix and normative preferences.

These points must be taken into account as we build global policies for monetary and financial governance and reflect on the nature of the public good in this regard. Patterns of global governance must permit flexibility and patience as complex historical systems adapt to the pressures of the rapidly changing market. Nowhere is this more important than in terms of global financial regulation, supervision, and monetary

management. Given what is expected of political authorities, especially states, when financial crisis strikes, we cannot afford major crises which might be prevented by more cautious policies. The lessons of the 1930s need not be learned over again. That would certainly not serve the public interest under any definition. If we start by conceiving of the monetary and financial order as belonging firmly in the public domain and not the plaything of private agents in the market, the task of global governance in the public interest may be greatly facilitated.

Conclusion

These points should lead us to question the “bicycle model” of liberal reform and market integration processes. The bicycle analogy (often invoked in relation to trade) compares liberal reform to a bicycle, one must keep peddling forward or one will inevitably fall off. This implies that policy makers should charge forward, committing their societies and polities to a liberal utopia, so that none of us will fall off the bicycle. Note the implication that bicycles do not even have a reverse gear. If we go fast enough, we may also lose our temptation to jump as well. In this way, dysfunctional political lobbies will not stand in the way of attaining the benefits of liberalisation.

One should, however, pause for thought. Avoiding precipitous and ill-thought-out liberalization, in particular in the financial sector of any country in the global system, should lead us to ask the broader questions about the ends of public policy in the domain of global money and finance. In this sense governments have at least partially

lost their way. The attempt at broad visions like that of Bretton Woods is long gone in these (fortunately, so far) less traumatic times. We need to ask ourselves in an ongoing fashion, what exactly *is* the public good, the public purpose in this era of global financial integration? There will doubtless be many answers, it is the debate itself that is healthy.

Liberalisation efforts in post-war trade took thirty-five years before even manufacturing industry tariffs came down to significantly low levels in developed countries (end of the Tokyo Round). Non-tariff barriers and trade in other sectors of the economy (agriculture, services) still await commensurate liberalisation and it will be a long process. The political obstacles to and disputes over trade and subsidy policy liberalisation are well known (O'Brien 1997), but the delays have had a seldom-observed positive effect.

All liberalisation implies restructuring processes, and if these happen too quickly, international co-operative agreements are likely to break down. The Kennedy Round tariff reductions were soon followed by a protectionist backlash in a number of sectors in developed economies. The long negotiation and adjustment periods which characterised the GATT/WTO process helped make liberalisation politically and socially acceptable. Societies, for better or worse, became more at home with the market, but it took a while (Milner 1988). Liberalisation efforts certainly smacked of political compromise, and there is nothing wrong with that.

The imperfect world of compromise and constraint is the only one we've got, so let's make the best of it. Precipitous liberalisation in the financial sector could have

rather less than pleasant consequences, which would call into question what has been achieved so far, especially in societies which are not yet politically and socially prepared for the necessary adjustments. Liberalisation should be built on firm socio-political foundations, and we should think carefully about what we seek to achieve, or it will collapse. Liberalisation is not an end in itself; it is supposed to be a means to a better world. If it fails to satisfy enough of the people enough of the time, then it will (and should) be discarded as a serious option in a democratic context.

So forget the bicycle theory. If liberalisation really is as good as advertised, then we had better take it slowly, and be prepared for lots of stops along the way. Let us also accept that liberalisation will never be a perfect state of affairs. We are unlikely ever to achieve a perfectly competitive market, or a seamless economic world without barriers to transactions of any kind. I am not sure we would want it. These are, after all, the abstractions of economic theory, not depictions of the world we actually live in. We can always have a better world, but not a best one. The search for the best is not only likely to backfire, but is also a worrisome utopian project.

Perhaps a more fruitful solution lies in a considerable strengthening of democratic institutions of accountability in our national, regional, and global levels of governance, particularly in the economic domain. This is of course easier said than done, and would certainly run into the fierce opposition of transnational corporate interests which most enjoy the freedoms and profits of the global markets. If efficient institutions are not established, it might also complicate a number of tasks in monetary and financial governance where speed is of the essence, such as crisis management.

It is however most unlikely that the powers of the corporate sector would be strengthened as a result of any such opening of the debate. It is equally unlikely that the market and the pursuit of individual private gain would be abandoned either. Some mixed economy system would continue, though the balance might alter.

If only Adam Smith were still around to heap his characteristic scorn on our contemporary hypocrisy in attempts at governance of the political economy. Smith clearly saw the market as situated in the public domain and argued persuasively that it must not be the plaything of "the dealers." At the very least, if scholars and policy-makers would read and understand his work and his profound scepticism about vested interests and the market system, we would have a better understanding of the public interest and the public good in a market setting.

Endnotes

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and *What is to be Done? Global Economic Disorder and Policies for a New Financial Architecture in the Millennium,* Universiteit van Amsterdam, 3 - 5th February, 2000, convened by Geoffrey Underhill and Karel van Wolferen. My thanks to discussants and participants in these events for their many helpful comments and criticisms. Generous financial support for this research was provided by Phase Two of the Global Economic Institutions Research Programme of the Economic and Social Research Council of the United Kingdom, grant L120251029.

1. Heilbroner discusses this point in his "Introduction to *The Theory of Moral Sentiments*" in Heilbroner 1986: 60-62.
2. As cited in Ibid.: 268.
3. See quotation from/references to Smith, above; also Friman 1990; Underhill 1998.
4. See discussion in Underhill (1998), passim and especially pp. 18-25, which looks at a case of transnational interests systematically capturing the policy process to structure the market to their own advantage. Also Underhill 1997c, which develops the point in relation to the financial sector, and Underhill 2000 which puts the case in more theoretical terms.
5. See a useful and extended discussion of the interplay of these variables in Story and Walter 1998, esp. chapter 5.
6. The point about expertise was made consistently in a wide range of interviews with public sector officials. See also Underhill 1997b.
7. This point was corroborated thoroughly during extensive interview research with

private and public sector officials alike.

8. Even in the United States, which is often portrayed as a prototypical codified and statute-based system of regulation with strong authority vested in public agencies, front line regulatory tasks are often performed by self-regulatory organisations such as the stock exchanges or National Association of Securities Dealers.

9. This is argued at length in Underhill 1999: 64-8.

10. Henry Morgenthau, US Treasury Secretary (1944), as quoted in Gardner (1981): 76.

11.My argument is not that private market pressures and the interests of corporate actors were ever absent in the post-war or any other period, but that their role has increased.

12. The draft proposals (Basle Committee 1999) are currently the subject of extensive consultations with the private sector and with authorities outside the Basle Committee G-10 membership; see for example IIF 2000a, 2000b.

13. The Wall Street financier Henry Kaufman has raised this issue in articles in the financial press. See as an example Henry Kaufman, “Too much on their plate,” *Financial Times*, 04 February, 1999.

14. The role of external pressure is clearly demonstrated in an extensive study of domestic financial reform in Korea and Thailand - see Zhang 1999. External pressures and lobbying interacted with internal political dynamics to render major restructuring and reform unpalatable, but capital account liberalisation seemed acceptable. This account was confirmed in my own interview research.

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