The Democratic Deficit in the Institutional Arrangements for Regulating Global Finance

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The spread of democracy and the benefits associated with this spread have been a recurring theme in post–Cold War discussions of international affairs. Expanded democracy has been seen as leading to more freedom for citizens, as contributing to international peace and stability, and as being generally a desirable goal at both the domestic and international levels. It is striking, then, that talk of democracy has been almost entirely absent from one of the most important issue areas of our contemporary world—the governance of global finance.

There are three easy explanations that can be given for this absence. First, global finance has been seen as involving highly technical private transactions that are best handled by experts or market actors operating as freely as possible from the uninformed political meddling that comes with democracy. Second, those states that have been most heavily involved in multilateral rule making in global finance have been the G-7 states—all of which are democracies and are therefore held accountable to their citizens for the rules they have created. Third, even if democracy should in theory be relevant for an emerging set of supranational institutions with considerable autonomy from individual states, it is not easy to see how the formalized procedures that have been associated with democracy might be applied there given the scale, level of complexity, and degree of informality of these institutions.

This article challenges these views by arguing that democracy is crucially important for the governance of global finance. Consistent with other articles in this issue of Global Governance, I argue that the governance of global finance involves highly political conflicts that should not and cannot be resolved by technical experts or markets alone. Given the development of new complex and interlinked sources of technical, private, and supranational authority that deviate from the types of formal political authority we normally associate with governance, it is necessary to move beyond an emphasis on formal procedures such as elections in discussing democracy.
I proceed by first discussing how the political nature of global financial regulation means it cannot be left to private actors or technical experts and is an issue area for which questions of democracy are relevant. In the following section I discuss the analytical, ethical, and practical merits of democracy. I then provide an account of key developments in post-1990s international financial regulation in order to assess the relevance of democracy for them. I focus on prudential regulation—regulation designed to shape the conduct of private firms so that their actions do not threaten the viability of the financial system.

The Political Character of Prudential Regulation

The argument that governance of global finance is best left to private actors and technical experts has been very strong in the area of prudential regulation. In the main international institutions concerned with prudential regulation, such as the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), or the International Organization of Securities Commissions (IOSCO), there is a heavy emphasis on technical reports and virtually no references to politics.¹

There are, however, a range of important changes in global finance that have undermined this tendency to minimize the role of politics in prudential regulation. Three sets of changes stand out. First, the severity and frequency of global financial crises have highlighted the fact that prudential regulation is not a relatively unproblematic administrative monitoring of market processes in which risks that are not controlled are willingly taken on by actors hoping to be compensated by high returns. Failures in prudential regulation can have catastrophic impacts on actors that have had no direct involvement in international financial transactions, including workers losing jobs due to currency crises or taxpayers having to bail out failed banks. In crises, the allocation of risks and rescue costs cannot just be dispassionately managed by experts or market forces because they involve a strong element of arbitrariness and negotiation.

Second, prudential regulation has become inextricably and reciprocally linked to other areas of regulation that have always been seen as more politically contentious. In addition to exchange rate policy, this includes trade liberalization and corporate governance. In the case of exchange rate policy, the 1990s demonstrated the linkages between exchange rate policies, currency crises, and bank crises. Prudential regulation thus becomes entangled with the broader politics of exchange
rates in which exporters, importers, and other interests have always sought to exercise influence for reasons unrelated to prudential regulation. Similarly, the adequacy of financial regulation has become a key issue in the pace of liberalization of trade in financial services and investment negotiated in the World Trade Organization and elsewhere. The East Asian financial crisis of 1997 and 1998 highlighted the links between corporate governance and prudential regulation, as a lack of transparency and mismanagement of nonfinancial firms were seen as linked to the failures of financial firms to properly assess risks. Yet corporate governance touches on politically charged questions of social and economic organization that have not traditionally intruded on discussions of prudential regulation.

Third, cross-border financial flows have created demands in the emerging international financial architecture for compliance with sets of international codes and standards, and this raises conflicts between national practices and political processes and international ones. This is especially problematic when developing countries are expected to comply with international codes and standards that have been developed by industrialized countries working through institutions such as the G-7, the G-10, or the Organization for Economic Cooperation and Development (OECD).

Recognition of the political dimension of prudential regulation has led to increasing integration of international institutions concerned with prudential regulation and more high-level political institutions. Before 1999, capacity for prudential regulation at the international level was fragmented into a series of groupings and organizations that were only connected informally or through joint participation in low-level committees such as the Joint Forum on Financial Conglomerates, which involved representatives from the BCBS, the IAIS, and IOSCO. Beginning with the Halifax summit in 1995, the G-7 began to play an increasingly organized and prominent role in the governance of global finance, with the G-7 finance ministers developing increasingly specific plans regarding the international financial architecture that the G-7 summit would review and endorse.

This culminated in 1999 with the creation of two new institutions in succession: the Financial Stability Forum (FSF) and the Group of 20 (G-20). The FSF brought together twenty-four representatives from all the major groupings and organizations concerned with prudential regulation, along with three representatives from each of the G-7 countries. Aside from integrating the formerly fragmented capacity to monitor and address problems of financial stability, the FSF brought technically oriented regulators into an arrangement in which the more politically oriented
G-7 plays a key role. Upon its creation, criticisms were raised of the FSF for its lack of representation from outside the G-7. Consequently, soon after the FSF’s creation its membership was expanded to include Australia, Hong Kong, the Netherlands, and Singapore, and it was stated that non-G-7 countries would be permitted to participate in FSF working groups. More important, though, the G-7 created the G-20, which grouped together finance ministers and central bank governors from the G-7 countries, Australia, and eleven large “emerging market” countries, along with representatives from the European Union and the Bretton Woods institutions. The G-20 is envisioned as a place for developed and developing countries to establish genuine dialogue about long-range international financial architecture questions in a relatively informal process modeled on the G-7. Implementation would be carried out both through the more formalized process at the IMF (in which the combined voting weight of the G-20 would be decisive) and through national implementation in the G-20 states themselves.

Taken together, changes such as those discussed in this section indicate the degree to which international prudential regulation has become more intensely political as the integration of issue areas, institutions, and nationally based financial markets has made it impossible to focus in an isolated way on the technical management of financial market transactions. Given the political character of the regulation of global finance, it is appropriate to inquire about the relevance to this issue area of the widely acknowledged best form of political governance—democracy. I turn to this question in the next section.

Democracy and the Regulation of Global Finance

Although democracy, in its most general sense, refers to control by people of their political institutions, it is often reduced to the more formal and procedural aspects of democracy that have been associated with democratic nation-states, such as competitive party elections. This narrow focus on formal procedures has become problematic today due to the migration of authority away from elected officials. Four types of authority are undermining traditional political authority: private authority, generated through collaborative institutions of market actors; technical authority, generated through bodies of scientific and technical knowledge; supranational authority, generated by the creation of global institutions with a degree of autonomy from nation-states; and popular authority, where citizens support or comply with a set of political
prescriptions that are generated by nongovernmental organizations and social movements rather than by legislatures. All of these developments reduce the significance of elections, legislatures, and elected officials. Contemporary problems, actors, and institutions have outgrown traditional formal democratic procedures.

Despite the limitations of traditional democratic procedures, democracy in its broader sense has become even more important. In part, this is simply because its association with freedom is increasingly seen everywhere as being of fundamental significance for meaningful human existence. More specifically and pragmatically, however, the often underrecognized discursive and deliberative properties of democracy play a crucial role in resolving conflicts and problems in a world that is increasingly constituted by discursive systems. Discursive system here refers to bodies of activity-shaping knowledge created through linguistic interaction, such as medicine or urban planning. In global finance, discursive systems range from a consensus on macrolevel initiatives by state leaders meeting in settings such as the G-20, to the unintended systemic consequences of the shared microlevel rules and expectations of individual financial actors buying and selling derivatives contracts.

Theorists such as Jürgen Habermas and John Dryzek have drawn our attention to the centrality of discourse and deliberation in democracy.² Habermas points out that law involves a fusion of facticity and norms that provides it with its unique capacity to regulate human conduct. This is accomplished through the expectation that laws be developed in an interactive deliberative process where their proponents justify them by invoking widely shared principles and norms. Democratic deliberation therefore involves more than bargaining and trade-offs among self-interested actors.

Democratic political deliberation is increasingly important today not just because it mobilizes consent in a manner similar to other discursive systems, but also because it plays a unique role in integrating and reconciling conflicts among these other systems, including those associated with private, technical, supranational, and popular authority. These four sources of authority have displaced traditional political authority in part because the rules and norms they produce resemble law both in their fusion of facticity and norms (markets and science, for instance, are accepted both because they are seen as good and because of their links to forces that are perceived as real) and in the public, contestable, and discursive way in which their rules and norms are developed. However, reconciling their differing discourses is not unproblematic. Traditional
political administrative power is inadequate to this task as well: "The required steering knowledge no longer seems capable of penetrating the capillaries of a communication network whose structures are predominantly horizontal, osmotically permeable, and egalitarian."³

Given the declining reach and significance of traditional formal democratic processes, it is important to find functional equivalents that are relevant in the varied locations in which public policies are being developed. Elsewhere W. D. Coleman and I have proposed six criteria for assessing the degree of democracy in a policy process: transparency; openness to direct participation; quality of discourse (does it address key issues or is it simply rhetorical, for instance); representation; effectiveness (democracy is undermined if there is insufficient organizational capacity to address problems); and fairness (the development of agreed rules about rules to guide deliberations).⁴ Criteria such as these illustrate the way democracy is applicable at the global level even without the presence of formal procedures such as competitive elections.

In the next section, I examine the relevance of this section's discussion of democracy for analyzing the developments in the regulation of global finance that have occurred since the end of the 1990s.

Democracy and Global Financial Regulation at the Start of the Twenty-First Century

In examining developments in global financial regulation since the 1990s, I make three main points with regard to the relevance of democracy. First, these developments involve a significant expansion of the types of discursive systems for which democratic governance is especially needed. Second, there has been significant progress in making the institutions that constitute the emerging international financial architecture more democratic. This confirms the perceived importance of democratic principles, even if these are not explicitly discussed with reference to the word democracy. It also confirms the feasibility of expanding democracy even in an international system populated by powerful self-interested state and financial actors. Third, despite this progress, there are significant ways in which the emerging international financial architecture remains too undemocratic. These points are evidenced by the two most important overlapping post-1990s developments in the regulation of global finance. The first of these developments is work done on codes and standards. The second is the work of the two institutions created in 1999 to oversee the emerging international financial architecture: FSF and the G-20.
Codes and Standards

A major focus of the work on the emerging international financial architecture since the end of the 1990s has been the development of international codes and standards in a variety of areas. Both the integration across sets of codes and the individual sets of codes themselves have been strengthened. After examining the way in which the integration across standards has been strengthened, I further illustrate the changes by looking at two particular areas of standard development: bank capital standards and corporate governance standards.

Strengthened integration is evident in the creation by the FSF of the Compendium of Standards, including twelve standards that, the Compendium notes, "have been designated as key and deserving of priority implementation." The twelve standards have been created by various bodies, and each includes a further set of more specific standards, as with, for instance, the forty recommendations on money laundering of the Financial Action Task Force. Strengthened integration is evident in initiatives taken to bring compliance with these standards into the conditionality processes at the International Monetary Fund (IMF). This will produce a highly effective form of leverage on governments seeking to borrow from the IMF.

The strengthened integration is also evident in the efforts of the FSF to fine-tune the effectiveness of the standards in creating market pressures for compliance. This has involved an assessment, through consultation with international financial firms, by the FSF of the relevance of the twelve key standards. It is hoped that these firms will use the key standards to assess risk, thereby putting market pressure on governments and firms to comply. The consultation involved questionnaire surveys, bilateral meetings, and focus group discussions with about a hundred financial firms of various types from eleven jurisdictions. This consultation revealed various weaknesses, which the FSF resolved to address, including a lack of familiarity with the standards and a desire for more quantitative indicators to facilitate comparision and modeling in risk assessment.

Following the 1990s, the most critical development in international bank regulation was the updating of the 1988 Basel Capital Accord, the most important international bank standard. Forcing banks to hold capital against risky assets constrains risky activity and provides a cushion against insolvency. Although the 1988 accord was adopted around the world and was widely agreed to have been a good step forward, it had become outmoded by the late 1990s. The existing categories of assets and accompanying risk weights were too crude (for instance non-OECD
country borrowers were treated identically), and some risks (such as operational risks from computer breakdowns) were not included. Thus, over the 1990s, the Basel Committee on Banking Supervision launched an extended process of report writing and consultation that resulted, on 16 January 2001 in the issuing of the penultimate draft of the new accord.

The most important difference between the two accords is the shift in the latter away from the earlier rigid quantitative approach to a more flexible and diversified set of options that rely more on the standards and monitoring capacity of private market actors. This is evident in the addition of an option for banks engaging in more complex activities to request permission from supervisors to use their own internal risk assessment procedures. For those banks that opt for the more conventional, standardized approach, the categories are refined (with, for instance, the single rate for corporate lending being broken into four), with the slotting of activities into one or another categories to be assisted by ratings from institutions such as Standard and Poor's. The flexibility and use of market pressures is well evident in the reorganization of the accord into three pillars, which, in addition to the determination of minimum capital standards, includes a pillar on the supervisory review process and one on market discipline. In both of these additional pillars there is an emphasis on disclosure of information.

In understanding the significance of the new accord, it is important to note that the regulatory context that surrounds it is vastly more developed than was the case with the 1988 accord. Aside from reams of reports that have refined regulators' methods for measuring particular categories of risk, the mechanisms for ensuring that the new accord is implemented worldwide are far stronger. Between the two accords, a series of regional groupings of bank supervisors have been linked to the Basel Committee, the membership of which has always been restricted to regulators and central bankers from twelve of the most industrialized countries. A Liaison Committee created by the Basel Committee to incorporate developing countries in its work produced in 1997 a set of Core Principles on Banking Supervision that have subsequently been incorporated in conditionality and other assessment processes at the IMF and World Bank. In October 1999, responding to criticisms of variations in the interpretation and application of the Core Principles, the Basel Committee issued Core Principles Methodology, a document that developed more precise criteria and procedures to facilitate domestic and international assessment of a country's compliance with the Core Principles.

Following the East Asian crisis, in which much of the blame for the failures of international financial markets was placed on the organizational character of East Asian business—disparagingly labeled "crony
capitalism,” there has been a sustained effort, led by the OECD, to create global standards of corporate governance. This is a striking development with remarkable political significance given the controversies that have accompanied past discussions of corporate governance, as with the United States defeating, in the 1970s, UN efforts to develop codes to control abuses by multinational corporations.

At one level, the development of codes of corporate governance can be seen as driven by a desire to promote the spread of competitive capital markets modeled on the Anglo-American ideal in which decentralized shareholders are able to monitor the performance of corporate leaders due to clear uniform legal requirements regarding disclosure of information, along with a developed financial services industry selling this information. Pressure can be imposed on managers through the sale of stock or even a hostile takeover. The push for codes of corporate governance can be seen either as a positive extension of a market-supporting institutional framework or as a mechanism to confer massive competitive advantages on financial and nonfinancial firms from the wealthy countries that already operate with such a framework.

It is significant, though, that the OECD has not restricted itself to the approach of the previous paragraph but instead has deliberately broadened the agenda and launched a large-scale consultative effort involving roundtables in various regions of the world. For instance, an OECD Observer article by the head of the relevant OECD directorate about the policy relevance of corporate governance starts by noting that “corporate governance is not just a business matter. It concerns the well-being of whole economies and populations too, and is a partnership question par excellence.” The OECD has teamed up with the World Bank, and the campaign for corporate governance codes is being carried out through their joint Corporate Governance Forum. The forum is described as having three functions: dialogue, which “is critical for building consensus for reform”; exchange of “experience, information and practices world wide”; and coordination between the many organizations engaged with governance, needed because “governance is a complex, multifaceted process” and “the roles of the public sector, private sector, capital providers and other stakeholders need to be fully addressed.”

The Work of the FSF and the G-20

In addition to its general responsibility for enhancing collaboration among regulatory institutions and in promoting codes and standards, the FSF sought immediately to more specifically address three controversial
areas in the emerging international financial architecture: offshore centers, cross-border capital flows, and highly leveraged institutions (hedge funds). The three reports varied in the degree to which they moved beyond conventional wisdom. The report on hedge funds, while highlighting problems such as the lack of data on their operations, broke little new ground in stressing the idea of simply improving existing bank regulation to better control the lending of regulated banks to unregulated hedge funds. The report on capital flows steered around controversial issues such as the Tobin tax. However, the FSF Report on Offshore Centers and a subsequent update in May 2000 that sorted specific offshore centers into three categories based on their status with regard to standards took a big step toward tighter control of the problem of inadequately regulated financial centers such as Nauru or Vanuatu. The report confirms the contribution of some offshore centers’ inadequate regulation to systemic instability or to fraudulent activities that undermine market integrity. When contrasted with the conventional wisdom of a few years earlier that held that offshore centers could not be controlled, the report is remarkably hard hitting and strong. It includes mechanisms to obtain information on the quality of offshore regulation and on the firms that make use of offshore centers. It also sets out ways to put pressure on the centers to comply with international regulatory standards through the use of positive and negative incentives, such as technical assistance and penalties or prohibitions to be imposed by nonoffshore jurisdictions on firms using uncooperative offshore centers. By naming names the FSF has significantly increased pressure on recalcitrant centers not just by moving a step closer to official measures against them, but also by undermining the confidence that even the clients of the more lightly regulated centers require before entrusting the latter with large sums of money.

As noted above, the G-20 was already politically significant because of its inclusion in a key process for governance of global finance of countries from outside the G-7. With members such as China, Russia, India, and Indonesia, it can claim to represent the world’s largest and most populous countries and ones with, historically, very different social systems. Together the G-20 countries account for 87 percent of world gross domestic product and about 65 percent of world population.8

As significant as its broad representation is the G-20’s rapid expansion of its agenda from narrowly focusing on the types of financial issues considered by the FSF to addressing concerns with the social dimension of globalization more generally. In the press conference following the 2000 Montreal meeting of the G-20, G-20 chair Paul Martin counterposed the narrow focus on domestic macroeconomic matters
associated with the "Washington Consensus" to the G-20's new "Montreal Consensus," with its emphasis on matters such as global public goods and social safety nets.9

Conclusion: Assessing the Relevance of Democracy for Post-1990s Global Financial Regulation

The two sets of post-1990s developments in global financial regulation that we have examined—strengthening of codes and standards and the work of the two new institutions, the FSF and G-20—confirm the three points made at the beginning of the previous section. I consider each in turn.

First, there are numerous examples of the expansion of the types of discursive systems for which democratic governance is especially needed. Codes and standards have been significantly strengthened, but not through the imposition of a centralized set of administrative procedures from a powerful political authority. Rather they have been developed through an ongoing process of deliberation and consultation in a variety of dispersed and often informal locations. The post-1990s experience reinforces the point that narrow quantitative approaches are inadequate. The addition of the second pillar in the new Capital Accord, for instance, highlights the need to exercise qualitative judgments in regulation. The emphasis of the Corporate Governance Forum on dialogue, exchange, and coordination highlights the point that the emerging international financial architecture is being built through the discursive coordination of discursive systems. The creation of the G-20, the primary function of which is the creation of consensus on strategic financial architecture questions through deliberation, highlights this point. Both the formulation and acceptance of codes, standards, and authority more generally are increasingly reliant on the type of deliberation that is a distinguishing characteristic of democracy.

Second, there has been significant progress in making the institutions that constitute the emerging international financial architecture more democratic, confirming the perceived importance of democratic principles and the feasibility of expanding democracy even in a world of power politics. The involvement of developing countries in the creation of the Core Principles, the efforts of the OECD to put in place a genuinely consultative process in the area of corporate governance, and the bringing in of major developing countries to a policy process formerly dominated by the G-7 are key examples from the previous section. Powerful actors have permitted this type of democratization
because it is needed to obtain the policy input and consent in implementation that is required if a complex and variegated emerging international financial architecture, and the stability that comes with it, is to be strengthened.

Third, the previous section also revealed that despite such progress, there are significant ways in which the emerging international financial architecture remains too undemocratic. Most striking is the privileging of financial actors and the tacit exclusion of other actors even where the implications of the issue at stake are clearly more than financial. This is evident by the G-20 taking on the task of including the social dimensions of globalization in their deliberations even though the institution’s membership consists of finance ministers and central bankers. An alternative would have been for the G-20 to have convened meetings of other ministers or even heads of state as is done by the G-7 and the European Union. It is also evident in the implementation of the OECD and World Bank’s consultation on corporate governance, which is dominated by financial actors despite their announced desire to be inclusive and their acknowledgment of the generalized political and economic significance of corporate governance issues. For instance, at the April 2000 Latin American Corporate Governance Roundtable, the panel “The Public Policy Perspective” included two chairs of Latin American securities commissions, the head of corporate affairs at the OECD, and a member of the OECD task force on corporate governance, who also serves as president of the Canadian operations of the multinational securities firm Morgan Stanley. Similarly, the increased emphasis on market pressures in enforcing codes, evident in the FSF’s consultation with market actors on their use of codes and in the third pillar of the new Capital Accord, tends to privilege financial actors and criteria in governance even if many of the issues addressed by the codes are of broader public significance.

One can also criticize the ongoing lack of participation by developing countries commensurate with the impact of global financial governance on them. This is evident in the exclusion of smaller developing countries without significant financial markets from the G-20. Despite their increased enthusiasm for consultations, the OECD and the Basel Committee do not include the developing countries as members, and the inclusion of Singapore and Hong Kong in the FSF hardly makes it much more representative.

Overall, then, this article has stressed that there are both theoretical and practical reasons to take democracy very seriously in discussions of global financial regulation. Some important democratization of
the emerging international financial architecture has occurred, but there is much more that is needed. ✰

Notes

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