1 Introduction: Financial Turbulence and Financial Governance

The world economy in the final years of the twentieth century was afflicted with financial turbulence. Millions of people in emerging-market nations lost their jobs, endured severe recessions, and suffered sharp declines in wealth. Life for them turned topsy-turvy as their nations' financial systems were thrown into crisis. Many residents of wealthy nations also experienced losses. U.S. citizens were less affected than residents of other nations. But they, too, were buffeted by the turmoil.

Journalists and other observers attributed the financial turbulence to large, disruptive flows of money spilling across national borders, spreading financial instability from one part of the world to others. There exists an "enormous, several trillion-dollar pool of money," wrote one commentator, "that sloshes around in what is effectively a supranational cyberspace, moving by computer in and out of off-shore banks and chasing profits in 24-hour markets, all largely beyond the reach of governments' control."[1] Colorful metaphors abound. The owners initiating these capital flows have been likened to legionnaires without commanders roaming the globe. They have been described as an "Electronic Herd" and "a new class of voters—

1. Jessica Mathews, "We Live in a Dangerous Neighborhood," *Washington Post*, April 24, 1995, p. A19.

stateless citizens of the world . . . casting votes for and against economic policies of the 200 or so nation-states."[2]

Cross-border finance was indeed often at the heart of the financial turbulence. Many developing nations could not or did not fully service their external debts in the 1980s. The resulting crises severely shook their economies. The Tequila crises pummeled Latin America in 1995 after the devaluation of the Mexican peso. The epidemic of Asian financial flu that began in Thailand in July 1997 spread contagiously to many other Asian nations, including Indonesia, Korea, Malaysia, the Philippines, Hong Kong, Singapore, and Taiwan. In August 1998 the debt default in Russia and the devaluation of its currency triggered a reevaluation of credit risks throughout the world's financial markets. Even domestically within the United States, most investors ran for cover in the fall of 1998. Brazil suffered a financial crisis in January 1999 and again in the summer of 2002, Turkey in late 2000 and early 2001, Argentina in much of 2001 and 2002.

Financial activity and financial markets were not invariably unsettled in the last several decades. Even during the less turbulent periods, however, journalists and analysts became increasingly preoccupied with issues of cross-border finance. Sweeping generalizations about "globalization," applied to most aspects of the world economy but especially to financial markets, are now commonplace among popular analysts and throughout the news media.

What should the average citizen believe about globalization, in particular the increasing linkages among national financial markets? Is the more rapid and pervasive movement of money across national borders helpful, promoting greater prosperity for all the world's citizens? Or is the periodic turbulence associated with cross-border finance hazardous, placing prosperity at risk for many of the world's citizens? Does the balance of benefits and risks vary significantly from one nation to another? Within any given nation, who gains and who loses among the different types of individuals and institutions? Does globalization entail poverty and injustice for some? Does it favor financial capital at the expense of labor?

Throughout most of the twentieth century, government officials and academic experts debated questions such as these about the financial and trade transactions crossing nations' borders. But the debates about globalization intensified, and the disagreements became even more polarized as the century drew to a close. Larger numbers of individuals and groups not

2. Friedman (1999); Jordan (1999).

hitherto engaged in the debates, dissatisfied with their experiences or perceptions of globalization, began to express strong views. The large street demonstrations in Seattle at the time of the Third Ministerial Conference of the World Trade Organization in the fall of 1999, in Washington and Prague during the spring and fall 2000 meetings of the International Monetary Fund and the World Bank, and at subsequent international meetings in numerous other cities are prominent illustrations of the increasing intensity and polarization of views.

It is a safe prediction that the debates and disagreements will continue in full force during the first several decades of the twenty-first century. Even more than before, average individuals will come to understand that the forces of cross-border finance and trade are having significant effects on their own welfare and the welfare of neighbors and fellow citizens. Thus average individuals will increasingly seek guidelines for assessing the controversies about globalization and for forming judgments about the policy decisions that are made in response.

Financial Activity

A first requirement for understanding cross-border finance is to have a sound understanding of the benefits and risks of financial activity *within* individual nations. To be sure, new and difficult issues arise with cross-border finance that are not present in domestic financial activity. Yet those insights about financial activity and financial markets that are truly fundamental apply to both the domestic and the cross-border aspects.

As explained in the initial chapters of this book, the financial system of a nation can be likened to a reservoir that collects the savings generated in the national economy. Savers place their funds in the reservoir. Investors draw funds out of it. Saving and investment decisions can be, and are, taken independently. The level of the reservoir rises and falls in response to changes in the economy. The existence of the reservoir greatly facilitates the operation of the economy, thereby enhancing the welfare of the nation's citizens.

Although the reservoir benefits the economy, it can also be buffeted by large waves and strong winds. The waves and winds can sometimes evolve into storms. The storms can in turn badly damage the economy and adversely affect welfare. To some degree, financial storms are inevitable. Financial activity is fundamentally fragile, potentially vulnerable to instability. These risks are also explained in the chapters that follow.

Cross-border financial flows are tantamount to a ladling of saving funds from one national reservoir to another. As the second half of the twentieth century progressed, individual nations' reservoirs became progressively better connected. The levels of the savings fluid in most national reservoirs are thus much more closely linked now than they were at the middle of the twentieth century.

The much higher degree of integration among national reservoirs today misleads some commentators into describing the world financial system as though it were fully unified, with a nearly uniform level of savings funds throughout a single global reservoir. The actual situation of the evolving world financial system, however, is intermediate. It is farther away from the case of completely separated national reservoirs than from the opposite case of a fully unified global reservoir. Nonetheless, the actual situation is an untidy, intermediate state well removed from either of the polar extremes.

The existence of an increasingly integrated world financial system greatly facilitates a vigorous and prosperous evolution of the world economy, thereby enhancing the welfare of many of the world's residents. Unfortunately, the increasing integration of national financial systems also enhances the risks associated with financial activity. Because financial activity is fundamentally fragile and potentially vulnerable to instability, cross-border finance exacerbates the potential instability. The growing pervasiveness of cross-border finance raises the probability that financial storms will occur and, if they do, can become more virulent and spill across national borders more contagiously than those arising in former times within domestic reservoirs. That financial storms on a worldwide scale are now possible was made vividly manifest by the events of August–October 1998.

Intermediate, Messy Globalization

The extent of integration among national financial reservoirs is, as just noted, partial rather than complete. The "intermediate-ness" in financial systems is just one of many manifestations of the same phenomenon in other aspects of the world at the beginning of the twenty-first century. The economies and the polities of individual nations, and hence their agglomeration in a global economy and a global polity, are at highly awkward stages of evolution. Chapter 4 explains this generalization and highlights its implications.

The complexity in the global economy and global polity has many dimensions and imposes numerous constraints on feasible evolutions for behavior and institutions. Throughout the following chapters, this book grapples with the world's hybrid, intermediate messiness.

Nothing better illustrates what I mean by messy and intermediate than the economic significance of national borders. National borders declined in *relative* importance over the second half of the twentieth century, as stressed in subsequent chapters. Yet national borders are still extremely important, economically as well as politically.

Journalism and popular discussions often repeat superficial generalizations about globalization and the diminished significance of national borders. Globalization is interpreted not merely as a widening, deepening, and speeding up of worldwide interconnectedness in all aspects of contemporary social life.[3] Many generalizations go much further. For example, the world at the beginning of the twenty-first century is often asserted to be a "global village," with the nation state "withering away."

Some observers view the trends approvingly. Examples include Kenichi Ohmae's *The End of the Nation State* (1995) and Thomas Friedman's *The Lexus and the Olive Tree* (1999).[4] Other observers perceive the trends as alarming. Examples include books whose titles warn the reader: *One World, Ready or Not: The Manic Logic of Global Capitalism* (William Greider, 1997); *False Dawn: The Delusions of Global Capitalism* (John Gray, 1999); *Global Village or Global Pillage* (Jeremy Brecher and Tim Costello, 1994); *Your Money or Your Life!: The Tyranny of Global Finance* (Eric Toussaint, 1999); and *World on Fire: How Exporting Free Market Democracy Breeds Ethnic Hatred and Global Instability* (Amy Chua, 2003).[5]

Much popular commentary about globalization is unhelpful in understanding the intermediate messiness of today's actual world. Sometimes the commentary amounts to nothing more than globaloney. The commentary correctly observes that the degree of economic integration across national borders, especially in financial terms, has increased greatly and will continue to increase. But it then often leaps, altogether unjustifiably, to such thoughts as full globalization has already arrived or will soon do

3. The phrase in the text is the definition of globalization offered by Held and others (1999, p. 2).

4. Friedman discusses both the favorable and problematic aspects but puts much more weight on the former.

5. Several colleagues at Brookings, concerned that anti-globalization views frequently overlook basic economic points, contribute constructively to this debate; see Burtless and others (1998).

so; identifiably different national economies are a thing of the past; national borders have virtually dissolved and no longer matter; nation states are unnatural units in a global economy and will soon be relegated to an unimportant status.

The awkward truth is that national borders, though less significant than in the past, still have enormous salience. A thoughtful approach to public policy choices for individual nations, and for the world as a whole, must eschew sweeping, superficial generalizations about globalization and focus instead on the status of the world as it actually exists.

International Collective Governance

Some situations in social groups or particular regions require collective action to supplement individual actions. Social and regional groups, or entire societies, thus choose to establish and maintain institutions to catalyze that collective action.

Collective governance is a rough synonym for collective action. *Governance* is in principle a broader concept than *government* because governance can subsume the activities of nongovernmental groups as well as government institutions.

Collective governance exercised through government institutions is likely to be required in numerous territorial jurisdictions, at a variety of levels. Local governments exist even for small municipalities. They are prominent features of social life at the level of provinces or states. National governments catalyze collective actions for nation states as a whole. The activities of international institutions established by national governments can be understood as nascent collective governance above the level of nations themselves.

In the messy, intermediate world of recent decades, collective-governance problems with dimensions spilling across national borders have grown in importance relative to problems of domestic governance. This growth of problems with cross-border dimensions is certain to continue well into the twenty-first century.

National governments will thus inevitably be forced in the future to interact more with each other. If they are wise and farsighted, the interactions will result in more cooperation. As part of that cooperation, the governments will ask international institutions to carry out a wider range of functional responsibilities and hence will delegate greater authority to them. This class of issues, at the broadest level, falls under the rubric of *the evolution of international collective governance*.

Collective governance is difficult and contentious even within a single nation with a relatively homogeneous population. In a heterogeneous, multination world of progressively increasing economic and financial interdependence, collective-governance problems are several orders of magnitude more difficult still. Much of this book analyzes the possibilities for, and difficult constraints impeding, the evolution of international collective governance.

The primary focus is on issues of collective governance for financial activity. Financial activity can be enormously beneficial in promoting growth and efficient resource allocation when it functions smoothly. Completely unconstrained financial activity, however, may not be able to deliver these benefits. As already indicated, the financial system reservoir is prone to storms. Problems to be discussed in the chapters that follow—for example, informational asymmetries, adverse selection and moral hazard, informational cascades, herding behavior and contagion, excessive volatility in asset prices—cause financial activity to be inherently vulnerable to instability. Corruption and crime can contaminate or be conducted through financial institutions.

The appropriate societal response to the dangers associated with financial activity is to establish and maintain a collective-governance "utilities infrastructure" for the financial system. Within an individual nation, the critical features of this infrastructure include standards for accounting, auditing, and information disclosure; legal procedures for enforcing contracts and adjudicating disputes; prudential supervision and regulation of private financial institutions; an effective but limited potential for crisis management and crisis lending ("lender-of-last-resort" provisions); and, not least, sound and predictable macroeconomic policies that shape the general environment within which the financial system and the wider economy operate. Although a few details of the collective-governance financial infrastructure within nations remain controversial, the general need for such an infrastructure is universally accepted.

If a well-functioning collective-governance infrastructure is a precondition for a domestic financial system to operate smoothly, why isn't an analogous infrastructure needed *on a world scale* for the smooth operation of the conglomeration of all national financial systems? One's intuition wants to respond that the same logic does apply at the world level. And the *economic* aspects of the logic are, indeed, persuasive. *If* there could exist, above the level of nation states, analogues to the functions carried out within domestic financial systems by nations' central banks and supervisors of financial institutions, the global economy and financial system could evolve in a smoother and more stable manner.

If cabbages were horses, all could ride like kings. But cabbages are not horses. And because the *political* preconditions are not satisfied in our messy intermediate world, the logic cannot be fully applied to the global financial system. Collective-governance institutions that can effectively carry out the functions of a supranational financial infrastructure do not yet exist.

To be sure, international institutions already exist with limited responsibilities in the areas of finance and trade. The International Monetary Fund (IMF) and the World Bank, created after World War II, are two important global financial institutions with universal (worldwide) membership. The Bank for International Settlements (BIS), originally created in 1930 to manage reparations and debts resulting from World War I, has evolved in recent decades into a bank and meeting place for the central banks of large, wealthy nations. The Organization for Economic Cooperation and Development (OECD), established in 1960–61 with membership originally only for the more advanced industrialized nations, was the successor institution to the Organization for European Economic Cooperation (OEEC), a post–World War II European institution. The General Agreement on Tariffs and Trade (GATT) was another creation of intergovernmental negotiations at the end of World War II. The GATT agreements are now folded into the successor World Trade Organization (WTO), created in 1995 after the 1986–94 Uruguay Round of trade negotiations.

These international financial and economic organizations are nascent venues for international collective governance. In the chapters that follow I will have much to say about intergovernmental cooperation and these international organizations that function as loci for it.

Controversies about the international organizations are frequently linked to the fierce debates about the merits and demerits of globalization. Joseph Stiglitz, a former chief economist at the World Bank, recently added fuel to the fire of globalization critics with his strident condemnations of the IMF. Stiglitz's polemic in turn induced vigorous, even strident, refutations, including the widely discussed response from Kenneth Rogoff, economic counselor at the IMF.[6] My book addresses the same issues about globalization and the international organizations. But I pay more attention to the challenges of collective governance and try to speak in a balanced, dispassionate voice.

A key fact is missing from the harsh criticisms that anti-globalization activists level at the international financial and economic organizations: these organizations are only new seedlings in the gardens of collective governance. When viewed against the long sweep of history, they have tentative mandates and highly limited authorities. Fragile plants may eventually grow into mature trees. Every mighty oak was once an acorn. But when appraising institutions for collective governance, it is essential not to confuse acorns or saplings with the venerable, deep-rooted trees that may eventually cast broad shadows on all their surroundings.

Pragmatic Incrementalism

This book argues that a clear need exists for the further evolution of international collective governance, not least for the building of an internationally agreed infrastructure for the world financial system. Once one recognizes the hybrid, intermediate status of the world polity, however, one has to be practical about how to make progress.

In the later chapters of the book, I encourage a stretching of intergovernmental cooperation in key economic and financial areas. And I strongly endorse a further strengthening of international financial organizations. I argue, in particular, for substantial evolutionary reform and a restructuring of objectives for the IMF.

My evolutionary approach, *pragmatic incrementalism*, does not shrink from strongly supporting a gradual strengthening of international governance. But neither does it unrealistically demand too much, too soon. Positioned in the middle of the road, pragmatic incrementalism is distanced

6. Stiglitz's criticisms are in *Globalization and Its Discontents* (2002); see also Stiglitz (2000). Rogoff's response circulated as "Open Letter to Joseph Stiglitz" (2002). Stiglitz cannot be accurately characterized either as an adversary of globalization or an enthusiast for it; his book addresses globalization issues from several perspectives. His often overstated and sometimes unfounded criticisms of the IMF, however, have played into the hands of those who assert sweepingly that the international financial institutions have exacerbated the evils of globalization. Stiglitz was the chief economist and a senior vice president at the World Bank during three years from 1997 to 2000; his criticisms of the World Bank are mild or absent altogether even on numerous topics where the analytical and policy views of the IMF and the World Bank are quite similar.

from the ditch on the right-hand side that is the extreme *untrammeled markets view* and removed from the extreme in the other direction, the left-hand ditch of the *sweeping institutionalist reform view*.

The untrammeled markets view sees government failures as pervasive, at both the national level and the nascent international level. In that view, efforts to mount governmental action are more likely to be "the problem" than a "solution." That view thus seeks to sharply limit collective governance. It trusts, or at least hopes, that markets and individual nations themselves will cope resiliently with any difficulties that materialize.

In sharp contrast, the sweeping institutionalist reform view sees market failures as pervasive, internationally as well as domestically. It believes that financial markets periodically go out of control, especially with cross-border transactions, and thus wants either to rebuild separation fences at national borders or else to delegate greatly enhanced authority to international institutions.

Neither the untrammeled markets view nor the sweeping institutionalist reform view is based on compelling analysis. Both views, furthermore, are politically unrealistic. Market failures and financial turbulence put great pressure on governments to "do something." The untrammeled markets advice to "Don't do something! Just stand there!" invariably buckles under crisis-generated political pressure (usually, appropriately so). The sweeping institutionalist reform view errs in the opposite direction by badly misjudging the relevant political constraints. Over the next decade or two, political considerations are unlikely to permit a radical increase in the authority of existing international institutions. Creation of additional international institutions, de novo, will be at least as constrained by political difficulties. The cosmopolitan dream of establishing global federalist governmental institutions—the beginnings of a world government to exercise collective governance formally at the world level—stands no chance of fulfillment for many decades into the future, at the earliest.

In today's world, political leaders and their citizens retain many illusions about the effective degree of their nation's sovereignty. They often fail to appreciate the significant differences between de jure sovereignty and de facto autonomy (to be emphasized in chapter 4). National governments therefore encourage each other and the international institutions only to tiptoe, timidly, towards the establishment of a nascent collective-governance infrastructure for the world financial system.

My stance of pragmatic incrementalism argues for moving more briskly. Timid steps on tiptoe will not keep pace with the rapid evolution of collective-governance problems. Pragmatism invariably requires caution. But it also often requires that decisions be expeditious and ambitious rather than protracted and timid.

Yet the only feasible approach is incremental. A series of continuing, small steps for strengthening international governance is the most that can be hoped for. Progress is an evolutionary path, not the playing out of an endgame that can be specified now for many decades into the future. For most of the economic and political areas where cross-border spillovers are growing in importance, simplified policy nostrums abound. But the nostrums—silver bullets in American cowboy parlance—either cannot magically resolve the problems or else have no prayer of being adopted.

H. L. Mencken observed that, for every human problem, there is a solution that is neat, simple—and wrong. Mencken's warning will serve well as the subsequent chapters dig deeper into the evolution of international collective governance for cross-border finance.

The Policy Dilemma for Individual Nations

Because of the cross-border and supranational nature of the problems on which I focus, this book necessarily concentrates on collective governance for groups of nations or for the world as a whole. The governmental decisions about finance and economics discussed here require cooperation across national borders. But the bulk of governmental decisionmaking in the world inevitably takes place within individual nations. For the most part, national governments steer courses that they themselves set independently.

For any individual nation, the government confronts a trade-off between national autonomy and openness to the global economy. Many dimensions of a nation's openness are of course attributes that cannot be changed and about which the nation's residents and their government cannot exercise any choice. No choices can be made, for example, about the size and location of the nation's geographical territory, its endowment of natural resources, and its past history of economic and cultural links with the rest of the world. But in some degree, varying considerably from nation to nation, a limited range of choice about openness does exist.

Some decisions of a nation's government, for example, require choosing how much relative weight to give to values, norms, and institutions that are indigenous to the nation. Some collective measures can help to shield the indigenous values and institutions from being overwhelmed by foreign values and institutions. Some national economic policies are better than others for promoting economic conditions within the nation that are identifiably, if only marginally, different from economic conditions abroad.

Extreme openness to the world economy, with no effort to nurture local conditions and to buffer them from foreign influences, threatens to undermine any separate national identity. Openness creates pressures for the acceptance of foreign values, foreign culture, foreign economic practices and conditions. Openness requires subjecting the national economy to the stringent, and sometimes fickle, discipline of foreign financial markets. Openness can generate political and social backlashes in domestic politics.

Yet openness can also bring very sizable potential benefits (discussed extensively in subsequent chapters). The scope for moderating openness to sustain indigenous values and institutions, furthermore, may be sharply limited in practice. No matter how much a nation's residents may wish to resist foreign pressures to become homogenous with the outside world, it must be asked whether the nation has cost-effective means at its disposal to achieve some degree of insulation and divergence from the rest of the world.

The difficult trade-off between autonomy and openness surfaces in a variety of ways and is important for all nations. But the trade-off is especially problematic for emerging-market nations that have advanced beyond early stages of economic and financial development and have begun to use modern technology intensively but have not yet evolved the increasing specialization and governance infrastructures of the most advanced nations.

Predictably, issues about the trade-off arise in an acute form for financial activity. The government of a small, open nation, for example, may even question whether the nation can feasibly sustain its own free-standing financial system with indigenously controlled financial institutions and indigenous supervision and regulation of those institutions.

Goals for the Book

When a legal case comes before a court, the plaintiff and defendant initially mobilize detectives or research lawyers to marshal and interpret facts. Later, on the foundation of the previous analyses, a prosecuting attorney and the defendant's lawyer will argue the case in court, acting as advocates. Ultimately, after listening to the arguments from all sides, a judge renders a decision.

My primary purpose in writing this book and its companion volumes has been to fulfill the functions of the detectives and research lawyers (what economists often describe as *positive* analysis). In the second half of the book, I also have a second, *normative* purpose, analogous to the advocacy functions of the lawyers arguing in court. Throughout, as detective and then advocate, my aspiration is to represent not just one side, but all sides, of the issues. I have therefore taken pains to identify places where there exist serious disagreements in analyses, interpretations, or advocacy positions. You, the reader, I perceive as the ultimate judge not only of the advocacy positions but also of the detective analysis that undergirds them.

As detective, my goal is to provide, in effect, a map and guidebook. Both citizens and policymakers need a set of basic concepts and analytical ideas that can enhance understanding of the problems of cross-border finance and international governance. Considerable background and some lateral vision are required before the issues can be placed in appropriate perspective. Hence the early chapters of the book are frankly pedagogical.

As the book was being written, I was prevented from going to my office one April day by street demonstrations and police barricades at the spring meetings of the IMF and World Bank. The demonstrators had gathered in Washington to protest poverty, inequality, injustice, and instability in the world economy. Those evils result, in their view, from globalization and inattention to the problems of poorer people and workers, both in the United States and in the developing nations of the world. The demonstrators appeared to believe, in one fashion or another, that international organizations such as the IMF, the World Bank, and the WTO are culpable in fostering those evils.

My reactions that day were troubled with cognitive dissonance. Like the demonstrators, I deplore the inequality, poverty, injustice, and instability that are widespread in the world. Like them, I believe that economic and financial globalization comes with serious costs, with a dark downside. And I believe that nascent international governance has at times been ineffective, even occasionally failing altogether to achieve its limited goals.

Having for much of my professional life studied the trends of increasing interdependence and their implications, however, I know that globalization has also generated substantial benefits. I believe that the majority of developing nations, not least their poorest citizens, would have fared even less well in recent decades if their economies had not become more open to the world economy. The fragile seedlings of the international organizations are merely ancillary extensions of the national governments who planted them. In the instances when the international organizations have failed in collective governance—have failed to improve welfare within individual nations and in the world economy as a whole—it is essentially because the governments of the major nations have failed to demand and support the appropriate policies. Assertions that the IMF, the World Bank, and the WTO are powerful, independent entities that on balance have systematically *worsened* the evils of inequality and instability are based on extremely shaky, typically insupportable arguments.

To genuinely understand the world's economic and financial problems, to propose coherent remedies for the costs of globalization and the failures of international governance, one must first identify the deeper causes. As concerned citizens, we should complain that poverty and injustice are widespread. We must try sensibly to attack their root causes. But in no valid sense can the international organizations be labeled the root causes of poverty or injustice. Beating up on the international organizations is about as effective as dragging the ministers of local churches into the courtroom, complaining that they are culpable because sinners' ways prosper.

My fondest hope for this book is that its analysis of fundamentals will constructively advance the understanding of the proverbial man or woman in the street. I have tried to explain the root causes of financial issues, the basic benefits and costs, in clear and simple language. The initial chapters in the book are my best shot at explaining, if you will, why sinners' ways can prosper in the realm of finance, yet why men and women of good conscience may agree that financial activity is, and should be, a prominent feature of economic life.

Perhaps my detective writing may even be useful to economist colleagues? Portions of the exposition, to be sure, will be old hat to specialists. But it cannot be helped if in places I bore my fellow economists. My chief aspiration is, again, educational—to facilitate a balanced understanding of these important issues for a wider audience of noneconomists, many of whom may hitherto have regarded the issues as too arcane or inaccessible to merit attention.

My subsidiary purpose in the book, like the prosecuting and defending attorneys in court, is to advocate practical policy recommendations. The second half of the book therefore summarizes broad guidelines for national policies and for intergovernmental cooperation. Whereas the early parts of the book look carefully in the rear view mirror at where the world was in the twentieth century, the final parts look ahead at where it is, and should be, headed over the first several decades of the twenty-first century.

Much of the recent policy concern with cross-border finance, and quite possibly your own interest in reading this book, is driven by anxieties generated by recent financial crises. Accordingly, much of what follows is about financial turbulence and how to mitigate its consequences when it does occur. When considering policy reforms, however, whether for an individual nation's government or for the world financial system as a whole, I eschew a preoccupation with crises. I am most concerned with the broader issues of how the world polity, and the world economy and financial system, should evolve in *noncrisis* periods. In effect, I primarily emphasize the *prevention* of economic and financial crises. The true preoccupation should be the encouragement of healthy growth and financial stability—*prosperity management* rather than crisis management.

Companion Volumes

I began the project that produced this book aspiring to write a single, integrated treatment of both the fundamentals of cross-border finance and specialized policy recommendations for enhancing international financial governance. I wanted the book to help a general audience develop understanding and to form views about the merits of the specialized recommendations beginning to be debated publicly. Simultaneously, I hoped the analysis would prove useful to policymakers and to fellow specialists, or at least constructively provoke them.

I succeeded in completing a draft of a single, integrated manuscript. But several friends and colleagues argued that that first manuscript was in places too technical for general readers, yet in other places too general for professional colleagues. My fondest hope, again, is to reach general readers, not merely fellow policy wonks. With the comfort of general readers uppermost in mind, I thus accepted the advice of my colleagues and rewrote the manuscript. The book as it now exists maintains a relatively even level of discourse and suppresses specialized, technical material that could deflect attention from top-level concerns.

Because the specialized analyses have been deleted, the normative recommendations in the second half of the book necessarily are summarized. Restructured and rewritten versions of the original specialized material may be found in three companion volumes, comprising the series *Pragmatic*

Choices for International Financial Governance, likewise published by the Brookings Institution. The companion volumes, titled *Crisis Prevention and Prosperity Management for the World Economy*, *Prudential Oversight and Standards for the World Financial System*, and *Crisis Management for the World Financial System*, are described further at the beginning of chapter 9. Policy specialists, as well as general readers who wish for more supporting argument, amplified descriptions of alternative points of view, or more extensive background than can be found in the second half of the book are urged to consult the companion volumes.

A Road Map and How to Read the Book

After this introduction, chapter 2 plunges into analytical fundamentals. It begins by reviewing basic ideas about financial intermediation, its substantial benefits, and its associated risks and costs. To clarify the essential ideas, chapter 2 suppresses the cross-border dimensions of financial activity and treats financial transactions as though they were entirely domestic.

Chapter 3 introduces the concepts of collective governance and applies them to the nonprivate institutions and procedures constituting the infrastructure of the financial system. It explains why such an infrastructure is essential for a healthy, stable evolution of financial activity. For clarity, it continues to suppress the international dimensions of financial activity, thereby highlighting the purely domestic aspects of collective governance.

Chapter 4 opens up the analysis to the actual world economy. The chapter emphasizes that the globe is divided into many diverse nations, each with a geographical territory defined by national borders and each with its own national government. The chapter sets out the dominant political and economic themes—often termed *political economy*—that are required background for coherently analyzing this multination world polity.

Chapter 5 begins the process of adapting the fundamental ideas in chapters 2 and 3 about financial activity and its collective governance to chapter 4's messy, intermediate world of heterogeneous nation states but increasingly integrated national economies. Chapter 5 contains some historical background and an empirical overview of recent decades. It also explains how and why the cross-border dimensions of financial activity are today so much more important than in the past.

Chapter 6 completes the adaptation of the fundamentals in chapters 2 and 3 to a context of many nations and multiple currencies. It discusses the potential gains from cross-border financial intermediation and introduces additional uncertainties and analytical issues that afflict capital flows in a multination, multiple-currency world. It also carefully analyzes the mishaps and instabilities that can characterize cross-border finance.

Chapter 7 begins by raising in more detail the question already identified above: whether, and if so, along what dimensions the multination world financial system may require some form of international utilities infrastructure for collective governance. It then steps back to address analytical issues about international collective governance at a general level. The discussion presumes that pressures will grow for the strengthening of various forms of intergovernmental cooperation and hence also for the strengthening of international institutions. Chapter 7 distinguishes between governance and government, reviews alternative forms and venues for intergovernmental cooperation, and then discusses the range of nascent governmental functions that might conceivably be exercised at international or supranational levels. It defines the range of conceivable functions for intergovernmental cooperation on financial issues and then concludes with an overview of the international financial institutions (intergovernmental consultative groups and actual international organizations) operating at the beginning of the twenty-first century. For readers not familiar with the institutions' origins and operations, the appendix to the book provides more detail about the IMF and other international financial institutions.

Chapter 8 provides background analysis for all the conceivable functions of intergovernmental financial cooperation—what has come to be called the *international financial architecture.* Not all the conceivable functions could or should be exercised in the short or medium runs. But sound analysis requires comprehension of a blueprint for the architecture as a whole, not merely for modifications that may be added in the near future. Chapter 8 emphasizes issues that have so far been relatively neglected in journalistic and academic debate. It highlights supranational collective surveillance of cross-border traffic regulations and of national exchange rate and macroeconomic policies. Because IMF lending intermediation among national governments in noncrisis conditions is much less understood than emergency financial assistance as part of crisis management, chapter 8 provides analytical background about that function for intergovernmental financial cooperation. The chapter concludes by examining parts of the blueprint that, though currently not regarded as important, are likely to become salient over the longer run.

Given the background in earlier chapters, chapters 9 and 10 shift into a forward-looking mode and turn to international governance issues that deserve high priority in the first decades of the twenty-first century. Both chapters summarize recommendations for strengthening collective governance, within nations and at international or supranational levels. Both explore *architectural reform*—how to nurture the evolution of key dimensions of a financial utilities infrastructure for the world financial system.

Desirable enhancements in the nascent world utilities infrastructure fall into three groups. Chapter 9 covers the first group, *supranational surveillance and lending intermediation*. National governments and international organizations should upgrade their collective monitoring of cross-border traffic regulations and of nations' macroeconomic, exchange rate, and balance-of-payments policies. Concurrently, they should streamline and strengthen intergovernmental lending intermediation for the liability financing of payments deficits in noncrisis periods.

Chapter 10 summarizes reform recommendations for the other two groups, *prudential financial oversight* and *crisis management*. Strengthened prudential oversight requires governments and international organizations to make further improvements in the surveillance, supervision, and regulation of financial activity and in the associated design and monitoring of financial standards. Improved capabilities for crisis management require greater intergovernmental cooperation for collective responses to financial turbulence, both domestic and cross-border; the needed procedures and capacities include the contingent provision of emergency lending during financial crises, the handling of moral hazard difficulties, and the involvement of private financial institutions in concerted lending.

The International Monetary Fund is the international institution most centrally involved in architectural reforms for supranational surveillance and lending intermediation and for crisis management. The IMF also has a prominent role in reforms for prudential financial oversight. Chapter 10 thus concludes with analysis of alternative views about the IMF's institutional mandate and recommendations for how it should be defined.

The recommendations summarized in chapters 9 and 10 are discussed and justified in detail in the three backstopping volumes in the companion series *Pragmatic Choices for International Financial Governance*.

The final chapters in the book provide concluding overviews, taking stock of the conclusions and complexities of the earlier analyses. Chapter 11 focuses initially on issues of cross-border finance as they arise for key policymakers in a single individual nation. The chapter subsequently reverts to the cosmopolitan perspective of chapters 8 through 10 where policy choices are analyzed as collective choices for the global community, not as choices for a single nation.

Chapter 12 summarizes an appropriate perspective for thinking about financial activity and financial turbulence. It provides the average citizen a balanced answer to the issues of financial globalization and what to believe about the progressively stronger linkages among national financial markets.

The stocktaking in chapter 13 focuses on the evolution of international collective governance for the world economy and financial system. It reviews main themes and broad principles and selectively highlights key political issues. An underlying objective for the concluding chapter is to sketch an interim vision of how the world polity and financial system might evolve for the first several decades of the twenty-first century.

Inevitably, some readers will not be able to take the time to read every chapter in the book. In recognition of that fact, this introduction and the final chapters are designed so that they may be read as a partial overview of main themes and conclusions. In the last movement of his final string quartet, Beethoven posed the question *Muss es sein?* (Must it be?).[7] If you should fall into the group of busy individuals with severe time constraints and hence feel forced to jump to a "bottom line"—Muss es sein?—your best recourse is to turn directly to chapters 11 through 13. That partial reading will at least permit you to sample the flavor of the book's analysis and its recommendations.

An inquiring reader, and certainly a reader not inclined readily to accept my analytical summaries, will not be satisfied merely by reading this introduction and the concluding chapters. The issues raised in the book are complex and controversial. A deep understanding requires an investment in the analytical framework that underpins the main themes and conclusions. Much the most informative way to read this book, therefore, is to follow the King of Heart's advice to the White Rabbit in *Alice's Adventures in Wonderland*: "begin at the beginning and go on till you come to the end: then stop."

Some readers dislike footnotes. Others find them useful, even indispensable. I follow a middle course about them in the chapters that follow.

7. Beethoven also supplied his own answer: *Es muss sein!*—Yes, it must be.

A majority of the footnotes identify the source of a quotation or additional sources in the literature. Those notes are intended to help intrepid readers who may want to know where to look to have the point at issue amplified, or to learn more about the perspective that other authors have taken. A few of the footnotes explain in a more detailed way, occasionally in a more technical way, the point at issue. Footnotes of this latter type are infrequent. General readers who prefer not to be diverted can ignore all the footnotes without any significant loss of the main argument.