Clubs, Neighborhoods and Universes:
The Governance of Global Finance

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August 2003

Prepared for delivery at the 2003 Annual Meeting of the American Political Science Association, August 28 - August 31, 2003. A previous version of this paper was presented at the 2003 ISA/IEESA conference in Budapest, Hungary. I am grateful to Anna Leander, David Vogel, John Mearsheimer, Brian Rathbun, Duncan Snidal, Alexander Thompson, Jana Von Stein, and Bill Wohlforth for their comments and suggestions on the theoretical sections of the paper. A Council on Foreign Relations International Affairs Fellowship provided generous research support during the early drafting of this paper. The usual caveat applies.

ABSTRACT

The globalization of finance and concomitant increase in financial crises increased the demand for a new "international financial architecture." Most of the scholarly and policy focus has centered on the role of the international financial institutions (IFIs) – the International Monetary Fund and World Bank. This paper argues that focusing on the IFIs overlooks the ability of the economic great powers to substitute governance structures as a means of advancing their common preferences. Because financial regulation produces a cleavage of interests between the developed and developing states, the developed great powers have relied on club organizations and forum-shopping among substitutable governance structures to create new modes of coordination. This argument is demonstrated by reviewing the development of new financial codes and standards in the wake of the Mexican and Asian financial crises.

1. INTRODUCTION

The current era of economic globalization has dramatically increased the size and depth of international capital markets. From 1994 to 2002, the valuation of all international debt securities almost quadrupled, from $2.3 trillion to $8.3 trillion. Over the past 20 years, the size of all banks' cross-border positions has increased from $1.4 trillion to $12.7 trillion.[1] The renaissance of global finance[2] has brought with it a rise in global financial instability. The frequency of banking and currency crises has risen to a level unseen since the interwar years (Bordo *et al*, 2001). The fallout from these shocks in Latin America, the Pacific Rim, Russia, and Turkey has triggered fresh demands to strengthen the "international financial architecture." That term is defined here as the set of rules, resources, and institutions designed to reduce economic instability via protection the solvency of significant financial institutions, public and private.

In the five years since the phrase was first mentioned, policy analysts have characterized the problem as a failure to provide the necessary global public goods. In response, they have proffered a welter of possible solutions (De Gregorio *et al* 1999; Council on Foreign Relations 1999; Ahluwalia 1999; Eichengreen 1999; Fischer 1999; IFIAC 2000; Overseas Development Council 2000; Williamson 2001). Their proposals focus on the international financial institutions (IFIs) – the International Monetary Fund and the World Bank. They implicitly or explicitly assume that these institutions will remain the focal point for global financial governance, and belittle reform efforts made outside these fora. These proposals include greater surveillance of emerging

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[1] International Monetary Fund, *Global Financial Stability Report – Statistical Appendix*, March 2003, p. 120; Bank of International Settlements, "External positions of banks in individual reporting countries," http://www.bis.org/publ/qcsv0303/anx2a.csv, accessed 25 April 2003.
[2] As O'Rourke and Williamson (1999) point out, there have been previous areas of financial globalization.

economies, a reallocation of responsibilities between the Bank and the Fund, rethinking the role of conditionality, and calls for greater transparency in IFI governance.

To date, many commentators (Kenen 2001; Stiglitz 2002; Willett 2002) believe that progress on this front has been minimal. The IFIs have made only modest changes on transparency issues (O'Brien *et al*, 2000). The IMF has defended the practice of conditionality (Rogoff 2003). The division of labor between the IFIs remains largely unchanged since 1998. The areas where the greatest progress has been made are the development of more rigorous financial codes and standards, and increased surveillance of emerging economies to ensure adherence to these standards.

Existing theories in the globalization literature are hard-pressed to explain this variation in global financial governance. The most prominent arguments made – race to the bottom arguments (Falk 1997; Cerny 1997) or capital dominance arguments (Goodman and Pauly 1993; Edwards 1999) – emphasize structural economic forces. The size and scope of capital flows and market dictates overwhelm states into what Friedman (1999, p. 86) labels the Golden Straightjacket of "free market vanilla", making it difficult to provide adequate rules or resources for a global financial architecture. While these structural approaches are theoretically elegant, they suffer from the tragic flaw of meager empirical support (Drezner 2000a, 2001a). In the case of global finance, these arguments cannot explain the ratcheting up of regulatory stringency that has taken place over the past five years.

In the last decade, ideational approaches (Haas 1992; Goldstein and Keohane 1993) have stressed the ways in which the emergence of shared causal beliefs can lead to significant policy change. In recent years, variations of this argument have been used to explain aspects of global financial governance (McNamara 1999; Chwieroth 2002). According to these approaches, the variation in global financial governance can be explained by the variation in ideational consensus

on the extant issues. The problem with this explanation of events is that such an expert consensus existed across the entire range of architecture issues (Williamson 2001; Willett 2002), yet progress was made only on the issue of standards.

The trouble with existing approaches to explaining the international financial architecture in that they ignore the salience of great power preferences. For financial regulation, the great powers are essentially the members of the G-7.[3] Once great powers are given pride of place, a revisionist model of regulatory coordination emerges – one in which a club of powerful states wields demonstrable influence over the course of global governance. These states will exploit the substitutability of governance structures, shifting decision-making fora to lock in their preferences. To enforce their interests, great powers rely on a combination of persuasion, coercion, inducement, and delegation strategies.

This argument is illustrated by describing the G-7 effort, following the Asian financial crisis, to establish global financial standards for states and financial institutions. The primary cleavage of interests among the relevant actors in global finance is between the developed and developing countries. Because of this distribution of interests, great powers will use "club" international governmental organizations – those bodies that admit only like-minded member states – as the primary fora to establish global financial regulations. The great powers, as developed economies, derive significant public goods benefits from coordination at a stringent level of regulation. In contrast, the distributional implications among these states are small. The preferences of developing countries diverge from the G-7. For states with unregulated or repressed financial sectors, the benefits of coordination at a high level are more uncertain, while the short-term costs are significant.

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[3] The G-7 members are the United States, Great Britain, Japan, France, Germany, Italy, and Canada. Russia is a member of the G-8, but is not included in the regular meetings of finance ministry officials.

This distribution of preferences renders universal-membership international governmental organizations (IGOs), with their norms of consensus decision-making, an inhospitable environment for financial regulation. Instead, great powers will rely on club IGOs to promulgate common regulatory standards. This preference for club IGOs also explains the lack of progress made on the other aspects of the architecture exercise. Most of the proposed reforms entailed the husbanding of governance among the IFIs. Despite the considerable influence the great powers possess in these institutions, their control of the IFI's agendas was less certain than in the club fora that will be discussed in this paper. Furthermore, many of the proposed reforms would have diluted their influence in the IFIs. It should therefore not be surprising the progress in other areas of the international financial architecture have stalled.

The rest of this paper is divided into five sections. The next section outlines a general theory of international regulatory coordination. The third section discusses why the primary cleavage of interests in the establishment of international financial regulation is between developed and developing countries. From this distribution of interests, one would predict great power forum-shopping and a reliance on club IGOs. The fourth section traces the development of global financial codes and standards following the Mexican and Asian crises. The fifth section examines G-7 efforts to enforce these standards at the global level, with a special emphasis on the enforcement of a global anti-money laundering standard. The final section summarizes and concludes.

2. A THEORY OF GLOBAL REGULATIONS[4]

The theory proposed here assumes that states remain the primary actors in world politics. Governments will naturally prefer the content and structure of any global governance systems to

mirror their own national systems of governance. This reduces the adjustment costs of any requisite legislative or bureaucratic changes for governments, as well as the costs for national firms to adhere to new rules and regulations.

The assumption that states are the primary actors in setting regulatory standards is hardly novel to this project. There is a burgeoning literature that discusses how states determine the pattern of transnational regulation. Vogel (1995) hypothesizes that there is a global "California effect": when great powers ratchet up their regulatory standards, other countries and firms have no choice but to comply with the new standards, thereby raising the stringency of global standards. Simmons (2001) provides an explanation of regulatory harmonization that relies on hegemonic state power. For Simmons, regulatory harmonization can be explained by whether the regulatory issue in question is a coordination game or a prisoner's dilemma, and by the extent of the externalities created by an absence of harmonization. Simmons and Vogel are the most prominent theorists assuming the primacy of states – but they are hardly the only scholars that make this assumption (Koremonos *et al* 2001).

However, one problem with existing approaches is that while they emphasize the power of states, they fail to delineate the sources and variations of that power. For example, Simmons admits that her model is based on the existence of a hegemonic actor. However, Braithwaite and Drahos (1999, p. 113) challenge this broad-based characterization of the international financial sector, observing, "These days no one state really leads the globalization of banking regulation…. the hegemony of the US in international monetary relations has no counterpart in banking regulation." Simmons provides no guidance when there is a multipolar economic order. Vogel does hint at the market power of particular states, but his discussion of the outcome is mechanistic – states consistently ratchet up their regulatory standards.

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[4] For a lengthier treatment, see Drezner (2002).

Like Simmons and Vogel, I will assume that states are the primary actors in the global economy. States are differentiated by their relative power. Markets have a gravitational effect on businesses – the larger the economy, the stronger the pull for firms to secure and exploit market access.[5] As demand increases, firms will have greater incentives to mirror that market's preferences. A great power has an economy of sufficient size and diversity such that it acts as a natural attractor for profit-seeking actors while being able to rebuff potential coercers. Great powers are price-makers, not price-takers.

To map out how great powers achieve their desired outcomes are realized when they share a set of common preferences, it is necessary to create a proper typology of international governmental organizations (IGOs). Borrowing from Walzer (1983), I divide IGOs into three categories: clubs, neighborhoods, and universes.[6] Universal IGOs, such as the United Nations or the IFIs, purposefully try to maximize membership. Universes have enhanced legitimacy, but the diversity of member preferences and the development of independent staffs make decision-making difficult. Club IGOs, such as the G-7 or the OECD, exclude states with different preference orderings and bestow benefits for in-group members as a way to ensure collective action (Buchanan 1965). Clubs are also useful for coercing non-members into compliance with club norms (Martin 1992; Drezner 2000a). Neighborhood IGOs, such as ASEAN, and the Council of Europe, use geography to place a natural limitation on membership. Regional hegemons can use these institutions to coerce or induce economically dependent allies to adopt their positions on matters of global governance (Drezner 1999).

[5] This is one reason why econometric methods to predict international trade flows are called "gravity models"; the presumption is that the larger an economy, the more traded goods that economy will naturally attract.
[6] Walzer's fourth category – families – is mostly absent from international relations. The few exceptions include the Commonwealth or the Organization of Islamic Conferences.

Regulatory coordination can lead to welfare gains for governments, through the reduction of transaction costs for international business and the reduction of social externalities for citizens. At the same time, such coordination can redistribute benefits towards states with domestic standards close to the agreed-upon international standard (Krasner 1991). If the benefits are significant and the divergence of preferences among the great powers is small, then a sizeable bargaining "core" exists, making successful coordination a likely outcome.[7] If the public benefits of coordination are minor and the divergence of preferences among the great powers is large, then a core will not exist, and the dominant strategy is noncooperation with any effort at global governance.

Table 1 displays the typology of governance structures generated from the distribution of state preferences; Table 2 summarizes the key characteristics of these different governance structures. The convergence or divergence of great power preferences is the main causal variable determining the emergence of effective global governance. If common regulatory standards were to have significant distributional effects among the great powers with few benefits, then no bargaining core exists, and the official enforcement regime for any proposed global standard will be either toothless or nonexistent.[8]

However, there is one important intervening variable: the preferences of the lesser powers, or peripheral states. These countries' preferences do not affect whether effective coordination occur, but they do affect the bargaining process, and therefore, great power strategies. If peripheral states oppose certain regulatory arrangements, they can block such arrangements in universal membership IGOs that rely on consensus decision-making procedures. Therefore, great powers must take the preferences of smaller states into account when they select both the bargaining and enforcement fora.

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[7] See Drezner (n.d.) for a formal derivation of this argument.

When there is minimal divergence of preferences among most states, great powers can be more confident in relying on universal-membership IGOs, such as the United Nations, for global governance. Universal IGOs can bring added legitimacy to an agreement. At the same time, however, great powers are likely to delegate the actual implementation of any regulatory regimes to non-governmental actors rather than international governmental organizations. This is partly for functional reasons; NGOs plugged into public policy networks can have a comparative advantage in gathering information and harnessing the requisite technical expertise (Mitchell 1998). More importantly, the delegation to NGOs also provides great powers a less public and more effective pathway of ensuring control over the regime's governance structure. Delegation eliminates the transaction costs that are inherent in a universal-membership IGO, particularly one that operates under a one nation, one vote principle. Governments can act like a board of directors: states devolve regime management to an NGO, while still ensuring that they can influence any renegotiation of the rules of the game.

When a bargaining core exists among the great powers but not with developing countries, the likely route to coordination is through club standards. Under this constellation of interests, the enforcement of standards becomes an issue. Great powers will create gather coalitions of the willing to generate a common set of rules and regulations. To formalize the coalition, core states will create or capture IGOs with strong enforcement and sanctioning mechanisms. Stringent membership criteria permit great powers to act in concert while limiting participation in rule formation to like-minded countries.

Because international governmental organizations are employed for different purposes in maintaining club standards than harmonized standards, different IGOs are used to manage this

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[8] This does not preclude non-state actors from trying to act as substitute enforcers. For more on the role of non-state actors, see Drezner (2002) and Gereffi *et al* (2001). For more on this category of outcomes, see Drezner (n.d.).

regime. Ideally, core states would prefer to use universal-membership IGOs with strong enforcement mechanisms. Opposition from peripheral states diminishes the likelihood of effective governance in those fora. This is particularly true if the IGO operates on a strict one-country, one-vote principle (Krasner 1985; Kahler 1992). If developing states form blocking coalitions within universal IGOs, great powers will rely on club-based IGOs to form "coalitions of the willing" as a coercion mechanism. The mere creation of a club can sufficiently alter market payoffs to non-members such that they want to join, even if they were better off under the status quo ante (Gruber 2000).

Club membership organizations are useful tools for coordinating monitoring and enforcement. Membership in a club raises the political costs of defection for members. In dealing with non-members, a club IGO can make it easier to pool resources to induce periphery members into agreeing to the core's regulatory regime. Material inducements, such as aid or technical assistance, can encourage peripheral states to accept the imposed standard. Developing country leaders that are sympathetic to the core position can also use pressure from an international organization to bypass entrenched domestic interests and other institutional roadblocks (Drezner 2003). For the most recalcitrant states, a club IGO greatly enhances the utility of multilateral coercion (Martin 1992; Drezner 2000a).

A number of studies illuminate the club standards model at work in other regulatory arenas. Stephen Krasner (1991) demonstrates how the United States engaged in forum-shopping and unilateral action to achieve a favorable distribution of rewards in the regulation of the telecommunications sector. John Braithwaite and Peter Drahos (2000) show a similar pattern with respect to the global regulation of nuclear power. The next section discusses why the distribution of interests in the matter of global financial regulation is likely to lead to club-imposed standards.

3. NATIONAL PREFERENCES FOR GLOBAL FINANCE

There are several reasons to believe that with regard to the international financial architecture, the primary cleavage in the distribution of state preferences would be between developed and developing countries. For developed countries, the benefits of global financial regulatory coordination at stringent levels of regulation are significant, while the adjustment costs are relatively minimal. For developing countries, the benefits of such coordination are tangible, but the adjustment costs are relatively significant.

For developed countries, there are three distinct benefits of coordination above some minimum threshold level of regulatory stringency. First, regulatory coordination lowers the transactions costs of transnational capital flows. When countries remove border-level barriers to exchange, regulatory frictions act as a substitute obstruction to deeper market integration (Drezner 2001a). A lowering of such costs improves both the static and dynamic efficiency of capital markets, a Pareto-improving move for all parties involved (Rajan and Zingales 2003). With segmented capital markets, the rate of investment is constrained by national savings. As capital markets become more integrated, individual countries are able to escape constraints on the magnitude of aggregate investment. The removal of national savings as a constraint on investment increases the balance of payments flexibility for developed governments (Feldstein and Horioka 1980).[9]

Second, the coordination of national financial regulation protects developed financial sectors from losing business due to lower profit rates. Regulatory stringency reduces the rate of return for financial institutions by imposing compliance costs. For banks, adherence to stringent regulations stringency can come in the form of higher capital adequacy ratios (Kapstein 1989) or implementing

[9] The United States' ability to sustain such a massive current account deficit as a percentage of GDP over the past few years is one obvious example of this benefit.

know-your-customer regulations (Florini 1999). Because of the high costs of regulatory compliance, firms with mobile assets have an incentive to engage in regulatory arbitrage. Internationally, lax regulaton in developing countries – in the form of lower standards *and* weaker enforcement – can act as a magnet for profit-maximizing firms.

Offshore financial centers (OFCs) represent the extreme version of this problem. OFCs are jurisdictions that have large numbers of financial institutions geared to perform services for non-residents. The comparative advantage of OFCs in international finance is their inviting tax and regulatory structures. OFCs have encouraged the creation of international business companies, and other offshore vehicles that facilitates the management of investment funds without close scrutiny. When successful, OFCs amass external assets and liabilities far out of proportion to domestic financial intermediation (IMF 2000). Between 1990 and 2000, cross-border lending to OFCs doubled to $850 billion, approximately 8% of all reported claims (Dixon 2001, p. 105). While financial institutions based in the developed world can open up operations in these countries, developed-country governments suffer from the transfer of capital to OFCs in two ways. First, significant amounts of tax revenue are lost. Second, the integration of OFCs into the global financial system increases systemic vulnerability to financial crises in offshore centers (Wechsler 2001).

The final benefit for global financial regulation is the protection offered to domestic investors holding overseas assets (Rogoff 1999). As the source for global liquidity, investors in these countries have incurred significant losses from financial crises triggered by inadequate financial regulation. According to the Institute for International Finance, private investors lost approximately $225 billion during the Asian financial crisis and some $100 billion when Russia defaulted on its debt in August 1998 (Rogoff 2003). Critics argue that these investors are the prime beneficiaries of any IMF-funded bailout (Stiglitz 2002). However, even if these critics are correct,

such bailouts only mitigate the financial losses – they do not erase them. From the perspective of G-7 governments, it is far more cost-effective to coordinate prudential regulation across countries rather than cover losses from financial crises after the fact.

For the developed economies, the costs of adjustment to ensure regulatory coordination would be expected to be small. Among the G-7 countries, differences in the policy content of financial regulation have narrowed over the past twenty-five years (Busch 2002, p. 11). Changes in the regulatory environment would not be significant.

This does not mean such changes would be free. The first cost that could emerge is the tradeoff between stringent regulation and financial innovation. Overly strict regulatory intervention raises the costs of creating new financial instruments (Rajan and Zingales 2003). In the case of derivatives, for example, extensive European regulation shifted the growth of these instruments to offshore markets (Braithwaite and Drahos 1999, chapter eight). Measuring the opportunity costs of lost innovation is an impossible counterfactual to calculate. However, interviews with finance ministry officials in several governments make it clear that policymakers in developed market economies were cognizant of this tradeoff but still believed that coordination provided positive value-added.

Another adjustment cost to global regulatory standards is specific to federal states, where much financial regulation is managed at the subnational level. States that delegate significant policymaking autonomy in financial regulation to local governments would have to bear the political burden of reallocating such authority back to the central government. For example, unitary states such as France would have little trouble altering their corporate governance regulations at the national level. Such an enterprise would be much more difficult in the United States, where corporate governance is the realm of state-level regulation. Some states –Delaware in particular – and the corporations headquartered in those states benefit disproportionately from the federal

system of regulation on this topic.[10] International regulatory coordination triggers costs in the form of the political battles necessary to superimpose global standards on top of subnational regulation.

For less developed countries (LDCs), the benefits of regulatory coordination can be appreciable but outweighed by the significant adjustment costs. The clearest benefit from regulatory coordination at stringent levels is the potential to maintain open capital markets. For countries and societies determined to maximize economic growth, maintaining an open capital account is a sizeable benefit (Quinn 1997; Henry 2000; Bekaert and Harvey 2001; Rajan and Zingales 2003). As Stanley Fischer (2003, p. 20) observes:

> What can be done to reduce the volatility of capital flows to emerging market countries? The first response would be for countries to shut themselves off from international capital flows. It bears emphasis that *despite the crises, and the arguments of many critics of globalization, almost no country has taken this route; the revealed preference of the emerging market countries is to stay involved with the international financial system* (emphasis in original).

Regulatory coordination is likely to reduce financial instability and its attendant social and economic costs.

However, it should be noted that the benefits of open capital markets for developing countries are more nuanced than neoclassical economic theory predicts. As Fisher notes, open capital markets lead to more growth, but also lead to more economic volatility. Several studies indicate that since the end of Bretton Woods, developing countries that remove capital controls are far more vulnerable to banking crises and twin crises of runs on banks and national currencies (Caprio and Honohan 1999; Kaminsky and Reinhart 1999; Bordo *et al* 2001).[11] Commentators across the political spectrum agree that inadequate regulation of financial sectors is the chief cause of these crises (Caprio and Honohan 1999; Lindsey 2002; Stiglitz 2002; Rajan and Zingales 2003).

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[10] Because of Delaware's minimal standards for corporate governance, more than half of the Fortune 500 companies are headquartered in the state (Chait 2002).

[11] LDCs that maintain capital controls are less vulnerable to banking crises but more vulnerable to currency crises.

In theory, stringent regulatory standards address this problem, but the empirical support for this claim remains murky (Arterta, Eichengreen, and Wyplosz 2001). .

Another problem is the indirect quality of the perceived benefits. Open and well-regulated capital markets do lower the transaction costs of foreign direct investment – in which foreign firms either control physical facilities located in the host country. Open capital accounts permit multinational corporations to repatriate their profits across borders, which should encourage more FDI. However, the primary effect of regulatory coordination is to facilitate flows of foreign portfolio investment – in which investors purchase securitized assets in the home country without exercising direct control. Various empirical studies suggest that less developed countries benefit far more from foreign direct investment (FDI) than portfolio investment (Borensztein *et al*, 1998; Agénor 2002). Even Fischer (2003, p. 17) acknowledges that "the relationship between capital account liberalization and growth is likely inherently weaker than that between current account liberalization and growth." So, while open capital markets should benefit LDCs in principle, in practice the benefits are somewhat murkier.

The political and economic costs to governments in emerging markets of regulatory coordination are considerable, although they vary based on the relative depth of the capital market. Governments with repressed capital markets incur political costs in the form of lost patronage power over the allocation of scarce finance. States with liberal capital markets incur economic costs in the form of a loss of comparative advantage relative to developed markets. Both types of countries also incur costs from implementing and enforcing the requisite financial regulation.

For countries with underdeveloped capital markets, the most obvious political cost of stringent regulation is the loss of the state's ability to allocate scarce finance to important political supporters (Lindsey 2002; Rajan and Zingales 2003). Governments can exploit repressed capital markets and privileged access to scarce foreign exchange to reward favored interests and political

supporters.[12] Leaders who want to stay in power will try to direct government benefits towards key backers. One of the most potent levers in less developed countries is access to government-owned or government-influenced financial institutions.

Stringent regulatory coordination undercuts this political lever in two ways. First, appropriate regulation creates oversight institutions to segment political actors from the financial sector. When successful, stringent regulation, properly aenforced, prevents clientilism in financial markets. At a minimum, regulatory oversight raises the political and economic costs of engaging in acts of favoritism. Second, regulatory coordination combined with access to foreign markets reduces the scarcity of capital in emerging markets. These institutions' ability to borrow from foreign sources dilutes political influence over their financial sectors.

For emerging markets with offshore financial centers, coordination raises the specter of losing their institutional comparative advantage. Less stringent regulations lower operating costs for financial institutions, permitting them to undercut international competition in terms of price. Lax regulatory enforcement has a similar effect of lowering the financial sector's marginal costs. This effect would be particularly pronounced in the potential loss of illicit capital flows. A former president of the IMF estimates the size of illicit capital flows at approximately 2-5% of global GDP, or upwards of $2 trillion (Camdessus 1998). Emerging markets with offshore financial centers have fewer disclosure requirements for customers. This provides black market entrepreneurs – such as narcotics traffickers – the opportunity to insert assets into the global financial marketplace. Although there are long-term risks to reputation for the emerging markets, many of these governments operate on the principle of "any capital is good capital" and are therefore loath to displace such investments in the name of regulatory coordination (Quirk 1996).

[12] A rent-seeking narrative has a different logic but a similar conclusion. In this scenario, state leaders exploit their positions of power to direct finance towards their own enterprises as a way of enriching themselves. In either scenario,

Finally, both types of emerging markets must invest in the training and implementation necessary to enforce any newly adopted regulations. From the perspective of a developed economy, such an investment would appear to be minimal. However, international relations scholars have observed that the transaction costs of compliance with the rules of the global marketplace can be considerable for developing country bureaucracies (Stiglitz 2002, p. 227; Jordan and Majnoni 2002, p. 19; Reinhardt 2003, p. 81-2). This is particularly true when dealing with international economic institutions, because of the complexity of the rules involved. The effective regulation of sophisticated financial markets requires a great deal of human capital, which is a relatively scarce resource in emerging markets.

For developed country governments, the benefits to global regulatory coordination in an era of globalization are transparent. The distribution of costs among these governments is relatively even, with federal states incurring slightly greater costs. For developing countries, the benefits of regulatory coordination at stringent levels require a long-term time horizon, and appear to be indirect. The costs are short-term and significant for the governments in power. Given this distribution of preferences, one would predict global governance in financial matters to follow a club standards model. Attempts to harmonize international financial regulation should originate in club-based organizations dominated by the economic great powers – the United States, the European Union, and Japan.

4. THE MOVE TOWARDS GLOBAL FINANCIAL REGULATION

Prior to the financial crises of the mid-to-late 1990's, there was not a significant amount of global regulatory coordination of financial markets. Porter (2001, p. 429) surmises, "Before 1999, capacity for prudential regulation at the international level was fragmented." What regulation

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government officials redirect capital away from their most efficient location as a way of benefiting themselves.

existed focused primarily on banking among the developed countries, i.e., the Basle Capital Accord and the Basle Concordat. Efforts to expand regulatory coordination to such areas as securities markets or money laundering were largely ineffective (Kahler 1995; Herring and Litan 1995; Padoa-Schioppa and Saccomanni 1995; Braithwaite and Drahos 1999).[13] *None* of the financial standards now considered to be important by the IFIs existed prior to 1996.[14]

This was due, in large part, to a lack of demand. Prior to the Mexican crisis, Herring and Litan (1995, p. 1) observed:

> [R]egulation of financial activities and the institutions that conduct them continues to be carried out mostly by national, and in some countries subnational, governments. By the same token, the problems countries have experienced in financial institutions have so far been confined largely to national borders. The now infamous savings and loan debacle in the United States had essentially no international ramifications. The same is generally true for… the troubles of banks in Japan and the Scandanavian countries in the early 1990s.[15]

At the same time, the *costs* of such regulatory coordination were perceived to be too great as well, as Kahler (1995, p. 71) pointed out: "National regulatory regimes in the financial sector are much more deeply embedded in political bargains, however, and internationally agreed changes are much more prone to pressures undermining their implementation." Prior to the wave of financial crises starting in early 1995, the calculation of most analysts was that the costs of coordinating financial supervision and regulation exceeded the benefits. Because the international externalities of national financial crises were considered to be small, no bargaining core existed for enhanced coordination.

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[13] In the wake of the Herstatt banking crisis in 1974, the Group of Ten countries created what is now known as the Basle Committee on Banking Supervision (BCBS), or Basle Committee. The BCBS was responsible for the Basle Concordat, an agreement to ensure that "no foreign banking establishment escaped adequate supervision" (Herring and Litan 1995, p. 99), as well as the Basle Capital Accord (Kapstein 1989, 1992).

[14] Among the codes and standards collected in the Financial Stability Forum's *Compendium of Standards,* eleven existed prior to 1996, and none of those are among the twelve "key standards." Sixty-nine standards were created between 1996 to 2002, including all of the twelve key standards. Some of these, however, do include elements devised prior to 1996. For example, the Basle Core Principles incorporate adherence to the 1988 Basle Capital Accord. See http://www.fsforum.org/compendium/compendium_of_standards_date_2002.html, accessed June 13, 2003.

[15] This observation also held for the crisis within the European exchange rate mechanism (ERM) in the early nineties.

The financial crises that hit Mexico in 1994/95 and East Asia in 1997/98 dramatically altered these perceptions.[16] In the wake of the Mexican peso crisis, a Group of Seven (1995) background paper on the IFIs stressed the need for greater coordination of regulatory authorities:[17]

> [W]ith today's highly integrated financial markets, there is a greater potential for the rapid transmission of financial disturbances. Close international cooperation in the regulation and supervision of markets is essential to the continued safeguarding of the financial system and to prevent erosion of necessary prudential standards…. In this context, we recognize the important initiatives being undertaken separately and jointly by various committees under the aegis of the BIS [Bank of International Settlements] and the International Commissions as well as by national authorities.[18]

A year later, at the Lyon summit, the G-7 (1996) statement focused more on the role that common financial codes and standards should play. The heads of state communiqué wanted "maximum progress" on "encouraging the adoption of strong prudential standards in emerging economies and increasing cooperation with their supervisory authorities; international financial institutions and bodies should increase their efforts to promote effective supervisory structures in these economies."[19] The focus of the G-7 was raising the regulatory standards of developing countries to first-world levels.

The Asian financial crisis merely reinforced and expanded the G-7 demand for global regulatory coordination in financial matters. The Mexican crisis was largely a product of how the country's large current account deficit affected the government's ability to repay its sovereign debt. The Asian crisis, in contrast, was worsened by a failure of these countries' financial sectors to efficiently allocate its access to cheap foreign capital, as Caprio and Honohan (1999, p. 46) observe:

> As additional funds became available from abroad, banking systems across east Asia funneled that money into their respective economies, ramping up a boom in real estate and equity prices. The lack of reliable financial information and trustworthy mechanisms for enforcing contracts (including

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[16] An excellent summary of this period comes from Kenen (2001), chapter one.
[17] All G-7 documents can be accessed at http://www.g7.utoronto.ca.
[18] Available at http://www.g7.utoronto.ca/summit/1995halifax/financial/6.html, accessed June 10, 2003.
[19] Economic Communiqué, Lyon G7 Summit, June 28, 1996, paragraph 11. Available at http://www.g7.utoronto.ca/summit/1996lyon/communique/eco1.htm, accessed June 12, 2002.

bankruptcy procedures) made for a situation where lending was happening without a clear sense of whether it would be repaid or what procedures would be followed in the case of bankruptcy.

The close relationship between the large banks, the primary industrial groupings, and the political elites badly compromised regulatory and prudential supervision of the financial sector (Claessens *et al* 1999; Lindsey 2002, chapter 7). Even more than the peso crisis, the spread of the Asian crisis to Russia and Brazil exposed both the complex interdependence of financial markets and the poor regulation and supervision of financial sectors among emerging economies.

At this juncture, a key question remained unanswered – which forum would decide the relevant financial codes and standards that merited global coordination? Although many considered the IMF to be natural focal point for such a decision-making process, the G-7 countries were exceedingly wary of using the IMF as the primary decision-making forum. The emphasis in the 1995 G-7 statement quoted above on the Bank of International Settlements (BIS) and its emanations is telling. Even before the Mexico crisis, some G-7 officials had observed that club-based models of governance like the G-7, G-10 or the Basle Committee were better-suited than the IMF to handle the regulation of financial matters (Padoa-Schioppa and Saccomanni (1995, p. 263-5).[20]

It could be argued that the IMF and World Bank were *already* clubs of the developed great powers, and therefore one would expect the IFIs to remain the principal foci of efforts to harmonize regulatory standards (Elliott *et al* 2003; Stiglitz 2002). Indeed, the IFIs, by operating as credit unions, are unique among universal IGOs in allocating voting rights by economic size rather than one country, one vote.[21] Over the fifty-year history of the institution, the salience of economic size has only increased in determining voting quotas (Woods 2000). Combined, the members of the G7

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[20] Even when the G-7 countries created the New Arrangements to Borrow at the IMF in the wake of the Mexico crisis, they insisted on retaining control for disbursement among the G-10 states (Kenen 2001, p. 4)

[21] Since the early 1980s, the determinants of quota size include, "GNP, official reserves, current external payments and receipts, the variability of current receipts, and the ratio of current receipts to GNP." (Van Houtven 2002, p. 5). For more on the weighted voting concept, see Zamora (1980) and Kahler (1992).

control more than 40% of the voting power among the IMF Executive Board.[22] This leads to an obvious question – given the unequal distribution of voting power within the IFIs, why wouldn't the great powers simply formulate and implement their regulatory policies within these institutions?

First, despite the weighted voting structure, there remains a strong norm of consensual decision-making within Fund governance bodies. Rule C-10 of the IMF's Bylaws, Rules, and Regulations states that at IMF Executive Board meetings, "The Chairman shall ordinarily ascertain the sense of the meeting in lieu of a formal vote."[23] In April 1998, the U.S. Executive Director to the IMF testified before Congress that she recorded a formal vote in only 12 out of approximately 2,000 IMF Executive Board decisions (quoted in Welch 1998, p. 3). One career IMF bureaucrat (Van Houtven 2002, p.24), in discussing the decision-making procedures within the IMF, observes:

> On complex issues there is, generally, an understanding that "nothing will be decided until everything is agreed." This practice offers valuable protection to the developing countries because interrelated issues may well involve financial matters, such as the rate of charge or the rate of remuneration, or other issues requiring a special voting majority for decision making. It provides the developing countries as a group with a potential veto power to ensure that the package as a whole would be acceptable to them.

A developing country Executive Director of the IMF concurs:

> [T]he Board of this institution is democratic. I can not imagine another forum where the person with only 1 percent of the shares can take the floor and argue as long as the others. This has a moderating effect on the G-7. (quoted in Bichsel 1994, p. 148)

The second constraint on great power influence is the size and professionalism of the IMF staff. Most international governmental organizations have small secretariats or are run by staff seconded from national governments. The IMF has a staff of approximately 2,650 individuals, attracting economists of the first rank into its ranks (Chwieroth 2002). The Fund has resident missions – its version of a diplomatic service – located in over seventy countries. The size, professionalism, and distribution of its staff provides the IMF leadership with independent sources

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[22] For the allocation of voting rights, see IMF, "IMF Executive Directors and Voting Power," at http://www.imf.org/external/np/sec/memdir/eds.htm#1, and "IMF Members' Quotas and Voting Power," at http://www.imf.org/external/np/sec/memdir/members.htm#1 (accessed May 29, 2003).

of information. One U.S. treasury official observed in an interview that although the U.S. wields considerable power in the IMF, "a strong staff can have influence and feel obligated to follow the consensus."[24]

Critics of the IFIs (Woods 2000; Elliott 2003) are undeniably correct in pointing out that despite these mitigating circumstances, the underlying voting structure influences governance decisions. However, the important point is that *relative to club IGOs*, the international financial institutions pose a more divergent set of actor preferences and greater transaction costs of decision-making. Even Woods (2000, p. 823), a critic of the current IMF governance structure, acknowledges:

> "The IMF and the World Bank enjoy a special place in the politics of international economic relations. Both organizations can claim a virtually universal membership and accountability to governments across the world. In this they are unlike most other international financial institutions, such as the Group of Seven (G-7), the Bank of International Settlements (BIS) the Group of Ten (G-10), and a host of other regulatory agencies. Indeed the claim to universal membership underpinned the IMF's recent insistence that deliberations on any reform of the global financial system should take place within the Fund's Interim Committee as opposed to any ad hoc or US-selected group of countries.

As the rest of this section demonstrates, however, the IMF's efforts to remain the focal point of reforming the international financial architecture have not succeeded.

By the summer of 1998, the Asian crisis was in full bloom. The G-7 recognized the need for further action, but was wary of giving the IMF too strong a role to play. The result was the creation of a new club IGO. The British Finance Minister and the U.S. Undersecretary of the Treasury for International Affairs advocated for the creation of a new institution to coordinate the erection of a new financial architecture of regulatory standards.[25] In response, the G-7 Finance Ministers delegated Bundesbank president Hans Tietmeyer to develop recommendations for any new

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[23] http://www.imf.org/external/pubs/ft/bl/rr03.htm#p3 (accessed May 29, 2003).
[24] Both of these constraints on great power influence are even more concentrated in the World Bank. The Bank, with approximately 10,000 employees, has a larger staff than the Fund. The norms of consensus carry greater weight in that institution as well (Bischel 1994; Stiglitz 2002).

institutions to facilitate the "cooperation and coordination between the various international financial regulatory and supervisory bodies and the international financial institutions."[26] The resulting report (Tietmeyer 1999) led to the creation of the Financial Stability Forum (FSF), which was tasked with "strengthening and… encouraging the development and implementation of international best practices and standards."[27] As one veteran IMF official observed (Van Houtven 2002, p. 41): "The Forum's responsibilities overlap in large part with the core financial tasks of the IMF."

The FSF was constituted as a club of clubs, heavily tilted towards the representation of G-7 interests. Each G-7 member is assigned three members – one slot for a finance ministry official, one slot for a central bank official, and one slot for a financial regulatory authority. Three other countries – Hong Kong, Australia, and the Netherlands – have a total of five members. The remaining sixteen members consist of representatives from the IFIs, the BIS and its emanations, and pre-existing regulatory bodies. Six of those sixteen representatives come from club-based organizations of which the G-7 were the principal members.[28] The first chair of the FSF was Andrew Crockett, General Manager of the BIS. The headquarters and staff of the FSF was seconded from the BIS headquarters.

The FSF commissioned a task force to draw up a list of codes and standards to be promulgated globally. While the committee made an effort at inclusion, G-10 representatives outnumbered developing country representatives, and club IGO representatives outnumbered universal IGO representatives (FSF 2000).[29] The IMF representative opposed the creation of any

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[25] The British effort was public; the American effort was private. Interview with U.S. Treasury officials.
[26] Statement by the G7 Finance Ministers and Central Bank Governors, Washington DC, October 3, 1998. Available at http://www.g7.utoronto.ca/finance/fm100398.htm, accessed June 12, 2003.
[27] The report is available at http://www.fsforum.org/publications/Tietmeyerreport.pdf.
[28] The full membership list is available at http://www.fsforum.org/about/who_we_are.html.
[29] The report and the list of members can be accessed at http://www.fsforum.org/publications/Issues_Paper_Standards00.pdf.

list of financial codes and standards, but was not able to prevent the FSF from agreeing upon a set of key standards.[30] In April 2000, the FSF (2000) promulgated what it considered the twelve key financial codes and standards for the international system.

Table 3 displays these standards as well as their creating organizations. Half of the standards emanated from club IGOs or private orders. Only one of the agreed-upon standards provided any differentiation for the country's stage of economic development.[31] These standards represented a significant ratcheting-up of stringency for the developing economies. When promulgated, many of these club-based standards were designed to represent "best practices" for the advanced economies.[32]

The composition of the FSF – as well as the standards highlighted for global implementation – was designed to ensure G-7 control over the standard-setting process. In discussing the process, Park and Wang (2001, p. 22) conclude, "In most of the forums or agencies drawing up standards, EMEs [emerging market economies] and DCs [developing countries] are not included or, at best, are underrepresented." Porter (2001, p. 438) concludes, "Despite their increased enthusiasm for consultations, the OECD and the Basel Committee do not include the developing countries as members, and the inclusion of… Hong Kong in the FSF hardly makes it much more representative."

The club IGOs that managed the establishment of global financial standards – the Bank of International Settlements (BIS) and its emanations – were appreciated by the G-7 members precisely because of their club characteristics (Padoa-Schioppa and Saccomanni 1995). One committee of American experts (IFIAC 2000, p. 100) observed:

> During its 70-year history the BIS has adapted well to large changes in the financial industry and central banking practices. ***Its ability to adapt was due largely to its limited and homogeneous membership***. An example of such adaptation is the way the BIS quickly rose to the challenge of

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[30] Interview with U.S. Treasury official, August 2001.
[31] The IMF created two standards for data dissemination. The General standard for less developed countries, and the Special standard for developed economies.
[32] Interviews with U.S. Treasury officials, August 2001.

> meeting regulatory deficiencies at the international level. The BIS has also demonstrated its ability to convince the most financially important countries to adopt its standards….
>
> ***The monthly meetings of central bankers are held behind closed doors. This is widely regarded as an advantage. It facilitates discussion and comments within the group***. The BIS keeps a low profile and is not well-known outside the circles of central bankers. [emphasis added]

It is noteworthy that the U.S. Treasury department, in its reply to the IFIAC report concurred with this assessment, agreeing that "expansion of membership in the BIS should be judicious and deliberate."[33]

Braithwaite and Drahos (1999, p. 156) record a similar assessment in comparing the Basel Committee – a BIS emanation – to the International Organization of Securities Commissions (IOSCO) – a universal IGO:

> During its first decade IOSCO's accomplishments were minimal assessed in terms of settled harmonizations. IOSCO compared unfavorably with the Basel Committee's accomplishments on the harmonization of banking standards during the same period. As one senior regulator who has been active in both IOSCO and the Basle Committee portrayed the difference: 'Basle is an example of leadership; IOSCO is an example of democracy. IOSCO had democracy with no leadership.'[34]

The creation of the FSF and the promulgation of stringent diverged significantly from recommendations of the epistemic community of financial experts. Williamson (2001), in reviewing this discourse, argues that "the degree of consensus exhibited is quite significant." There was agreement that the IMF should pay greater attention to the relevant financial codes and standards in its surveillance function. However, the bulk of this discourse focused on how to reallocate the division of labor between the Bank and the Fund, how to improve IFI accountability, and whether the IMF should play a role as the lender of last resort (Fischer 1999; Williamson 2001; Willett 2002). The failure of this consensus to affect real change in G-7 policy preferences undercuts

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[33] U.S. Treasury Department, "Response to the Report of the International Financial Institution Advisory Commission," June 8, 2000, p. 42.

[34] See Simmons (1999) on IOSCO's weakness, though Braithwaite and Drahos (1999, p. 158) suggest that its influence has grown in recent years.

epistemic community or ideational arguments about the regulation of globalization. As Porter (2000) concludes, "The strong and overt political guidance exercised by the G-7 over the FSF was a marked change from the earlier heavily technical governance of the regime."

5. ENFORCEMENT OF GLOBAL FINANCIAL STANDARDS

With the publication of the FSF's *Compendium of Standards*, the process of devising the relevant financial codes and standards clearly took place within a club IGO. However, the question of enforcement in the face of potential LDC resistance remained an issue. The G-7 countries pursued a three-track policy on this issue. The first track was to link access to IFI resources to compliance with the twelve key codes and standards. The second track was to rely on club IGOs in lieu of the IFIs to coordinate sanctions against noncompliant countries. The final track was to rely on market-led enforcement, by communicating/publicizing national compliance with the relevant standards and codes to private sector financial institutions and rating agencies (Goldstein 2000; Porter 2001, p. 433). Because market-led enforcement was in part contingent on the success of the G-7 in tying noncompliance to some form of official approbation, the first two tracks will be the focus of the rest of this section.[35]

On access to IFI resources, Lamberte (2000, p. 15) notes: "The G-7 seems to follow a hard-line approach." In September 1999, the G-7 Finance Ministers initially argued that, "Countries should be encouraged to demonstrate their commitment to making rapid progress towards full compliance with existing international codes as part of IMF and World Bank conditionality when the IFIs extend loans or credits."[36] However, resistance from LDCs and the IMF staff made this issue a contentious one. The consensus decision-making structure of the IFIs rendered the G-7

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[35] See Mosley (2003) for a skeptical appriasal of market-led enforcement, and Reisen (2002) for a more positive assessment.

unable to force through explicit conditionality between compliance and access to the pre-existing range of IMF resources. However, the G-7 was able to link standards compliance to the new Contingency Credit Line, envisioned to assist countries with sound financial sectors but threatened by financial contagion (Kenen 2001, p. 126-7).[37]

The G-7 countries pushed harder to have the twelve key standards incorporated into the IMF's surveillance function.[38] This move also met significant resistance from the developing country members of the IMF's key decision-making body, the International Monetary and Finance Committee. Their primary concern was the costs of compliance to LDC governments:

> *Russian IMFC representative*: "[W]e oppose hasty decisions to include the assessment of observance of standards and codes in the practice of the Fund's surveillance activities…. their implementation by certain countries requires substantial effort and/or outside technical assistance."[39]
>
> *South African representative*: "[U]niversal application requires to be implemented with due flexibility. We urge the Fund to take greater cognisance of the different levels of development among members seeking to implement and to comply with the wide new range of elements of strengthened surveillance."[40]
>
> *Indian representative*: "I must also add, however, that the plethora of these codes, standards and principles are overwhelming and highly demanding of manpower and financial resources. Not only do these involve avoidable micromanagement but they also have a potential to become overly intrusive vis-à-vis national authorities."[41]

The IMF staff concurred with this assessment (Van Houtven 2002, 54-55). Stanley Fischer, the IMF's Deputy Managing Director at the time, observed in June 2000: "There is a concern in some

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[36] G-7 Statement of Finance Ministers and Central Bank Governors, September 25, 1999. Available at http://www.g7.utoronto.ca/finance/fm992509state.htm.
[37] In particular, adherence to the IMF's Data Dissemination Standard and the Basle Core Principles are prerequisites for access.
[38] Statement of G-7 Finance Ministers and Central Bank Governors, Washington, D.C., April 16, 2000. Available at http://www.g7.utoronto.ca/finance/fm001604.htm. See also the statements of the G-7 finance ministers to the IMF's International Financial and Monetary Committee – especially those by U.S. Treasury Secretary Lawrence Summers and French Finance Minister Laurent Fabius – at http://www.imf.org/external/spring/2000/imfc/.
[39] http://www.imf.org/external/spring/2000/imfc/rus.htm,
[40] http://www.imf.org/external/spring/2000/imfc/zaf.htm.
[41] http://www.imf.org/external/spring/2000/imfc/ind.htm.

countries that the Fund is pushing too hard for the implementation of these standards. Maybe it is true that we are sometimes risk overburdening their absorptive capacity."[42]

These objections managed to delay but not prevent the IMF from agreeing to expand its surveillance activities to match the codes and standards highlighted by the FSF. By acting as a G7-endorsed focal point, the FSF *Compendium of Standards* prevented any alternative set of standards or ideas from acquiring significant support (Schelling 1960; Garrett and Weingast 1993). In 2000, the IFIs agreed to expand their Reports on the Observance of Standards and Codes (ROSC). One victory for the developing countries came in the decision to make the ROSC "modules" voluntary rather than mandatory. However, this was only a nominal success. One U.S. Treasury official pointed out in an interview that a LDC government decision *not* to release its IMF assessments publicly would in and of itself "raise eyebrows" in financial markets. Furthermore, as one OECD economist (Reisen 2002b, p. 12) points out: "how 'voluntary' is the adherence to standards if there is an implicit link to IMF lending programmes?" As of the end of 2002, more than 70% of the ROSC modules had been made publicly available on the IMF's web site (IMF 2003).

A year into the ROSC process, the IMF staff (2001) reported the following reactions from developing country participants:

> Participants remarked on the shift in attitude that had taken place on this point over the past two years. Participants noted that a striking sign of progress was that the value of international standards is now taken as given, and is no longer a subject for debate.
>
> However, concerns were also expressed. The major concern of some country authorities was for greater participation by developing and emerging market countries in the development of international standards. While some standard-setting bodies already have wide membership or conduct consultation with non-member countries, participants at the Conference agreed that more should be done to reflect the views and needs of developing and emerging market countries. [43]

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[42] Stanley Fischer, "The IMF and the Financial Sector." Speech given at the Seminar on Financial Risks, System Stability, and Economic Globalization, Washington D.C., June 5, 2000.
[43] IMF Policy Development and Review Department, "Quarterly Report on the Assessments of Standards and Codes," June 29, 2001. Available at http://www.imf.org/external/pubs/ft/stand/q/2001/eng/062901.htm.

Developing country officials and economists also voiced concerns about the implementation costs of the new set of financial standards (Almonte 2000; Park and Wang 2001)

By November 2002, the World Bank and IMF recognized the Financial Stability Forum's twelve key standards – and only those twelve key standards.[44] As of April 2003, the Fund had conducted 291 separate ROSCs in 74 different jurisdictions.[45] The chairman of the British Financial Services Authority (Davies 2003) recently commented that surveillance of national compliance with these standards and codes is, "now consuming a significant proportion of the Fund's resources."[46] The IMF (2003) Executive Board agreed, noting that, "standards assessments are being increasingly integrated into Fund operations."[47]

The G-7 was able to maximize the legitimacy of its club-derived standards by relying on a universal IGO with treaty status to help with enforcement. As Eatwell (2000, p. 10) concludes, "the IMF is using a treaty-sanctioned surveillance function to examine adherence to codes and principles that are not themselves developed by accountable treaty bodies." At the same time, because of the IMF's universal membership and consensus decision-making structure, the G-7 was thwarted from achieving all of its enforcement goals within the IFI structure.

The G-7 relied on club IGOs to ensure that the most flagrant violators of the financial codes and standards – countries with offshore financial centers or significant amounts of official corruption – faced additional sanctions. The choice of club IGOs was quite conscious. One

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[44] "List of Standards, Codes and Principles Useful for Bank and Fund Operational Work and for which Reports on the Observance of Standards and Codes Are Produced," November 2002. Available at http://www.imf.org/external/standards/scnew.htm.
[45] Information available at http://www.imf.org/external/np/rosc/rosc.asp.
[46] Howard Davies, "Is the global regulatory system fit for purpose in the 21st century?" *Monetary Authority of Singapore Lecture Speech*, 13 May 2003.
[47] "IMF Executive Board Reviews International Standards." Public Information Notice No. 03/43. Washington, DC: International Monetary Fund. Raghuram Rajan, the IMF's chief economist, recently observed in an interview that the IMF was paying more attention to the question of financial regulation. See the interview at http://www.rediff.com/money/2003/jul/04inter.htm.

American policymaker (Wechsler 2001, p. 41) described the problem with regard to money laundering:

> [A]ny strategy had to be global and multilateral, since unilateral actions would only drive dirty money to the world's other financial centers. Yet Washington could not afford to take a 'bottom-up' approach of seeking a global consensus before taking action; if the debate were brought to the U.N. General Assembly, for example, nations with underregulated financial regimes would easily outvote those with a commitment to strong international standards."

Because of this distribution of preferences, the great powers turned to club IGOs – namely, the Financial Action Task Force (FATF), OECD, and the FSF. Space constraints prevent a full discussion of the OECD effort to clamp down on tax havens and the FSF effort to "name and shame" unregulated OFCs. The FATF initiative to enforce anti-money laundering standards functions as an exemplar case of club standards.

In June 1999, the G-7 heads of state pushed for FATF to take an even more aggressive posture towards non-members whose laws appeared to tolerate money laundering.[48] In February 2000, FATF published criteria to identify "non-cooperative countries and territories" (NCCTs), a schedule for selecting and evaluating jurisdictions for NCCT status, and a menu of "countermeasures" for those governments that refused to comply with FATF requests. The countermeasures ranged from the issuance of advisories to domestic financial institutions to the most serious possible sanction: "conditioning, restricting, targeting, or even prohibiting financial transactions with non-cooperative jurisdictions." (FATF 2000a, p. 8).

FATF members reviewed the first group of possible NCCTs between February and June 2000. 29 jurisdictions were assessed, and 15 were listed as NCCTs (see Table 4). The jurisdictions ranged from microstates in the South Pacific to the Russian Federation. FATF demanded that these countries take the legislative and administrative steps to criminalize money laundering, establish

centralized financial intelligence units, cooperate with other national authorities in money laundering investigations, and require banks to file suspicious activity reports to the government. With regard to the NCCTs, FATF (2000b, p. 12) warned, "should those countries or territories identified as non-cooperative maintain their detrimental rules and practices despite having been encouraged to make certain reforms, FATF members would then need to consider the adoption of countermeasures." A month later, the G-7 Finance Ministers strongly supported FATF's NCCT initiative as well as the potential sanctions that backed up the threat. The G-7 (2000) stated: "We are prepared to act together when required and appropriate to implement coordinated countermeasures against those NCCTs that do not take steps to reform their system appropriately, including the possibility to condition or restrict financial transactions with those jurisdictions."

Table 4 summarizes the extent of NCCT concessions, as well as the FATF response. Of the fifteen NCCTs, four of them – The Bahamas, Cayman Islands, Liechtenstein, and Panama – acquiesced completely, passing all of the necessary anti-money laundering laws and staffing the requisite agencies to implement those laws. Another seven countries – Cook Islands, Dominica, Israel, Lebanon, Marshall Islands, St. Kitts and Nevis, and Russia – made significant concessions, enacting comprehensive legislation but not implementing it immediately. Three more jurisdictions – Niue, the Philippines, and St. Vincent and the Grenadines – passed laws that addressed enough FATF demands to temporarily avoid sanctions. Finally, Nauru made minor but insufficient concessions, leading to the FATF imposition of countermeasures in December 2001. In total, 73% of the target countries made major concessions prior to the implementation of any economic sanctions. The demonstration effect of the first round of the NCCT process, combined with the enhanced salience of money laundering in the wake of the 9/11 attacks, caused several other

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[48] See the June 18, 1999 Communiqué by G-7 Heads of State and Government at http://www.g7.utoronto.ca/g7/summit/1999koln/g7statement_june18.htm.

potential targets of coercion to preemptively adopt rigorous anti-money laundering measures (Drezner 2001b).

There is clear evidence to support the contention that these jurisdictions altered their laws in direct response to the FATF threat of economic coercion. When Lebanon passed its anti-money laundering legislation, its central bank governor explicitly stated that the law was designed to meet FATF's criteria.[49] The Dominican Finance Minister urged for the passage of an anti-money laundering bill in order to escape the FATF "blacklist."[50] When Russia was debating its anti-money laundering legislation, the Russian Finance Minister and the chairman of the Duma's banking committee explicitly urged passage in order to avoid FATF countermeasures.[51] Other targets expressed similar sentiments, either in public or in negotiations with FATF officials.[52] Although media coverage of this initiative has been scant, what reporting there is confirms this assessment.[53]

The G-7 countries used persuasion and inducements as well as sanctions to ensure broad acceptance of the need to ratchet up anti-money laundering standards. The G-7 encouraged the creation of FATF-style regional bodies in the developing world, such as the Caribbean Financial Action Task Force and the Asia-Pacific Group on Money Laundering. There are currently five regional bodies with a collective membership of 108 jurisdictions.[54] For these regional groups, the G-7 proffered technical assistance to ensure adherence and recognition of the FATF Forty Recommendations on Money Laundering. By August 2001, over 140 countries and territories had publicly acknowledged the FATF 40 as the accepted international standard for anti-money

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[49] "Lebanon Approves Money Laundering Law," Reuters, April 10, 2001.
[50] "Opposition in Dominica Blasts Anti-Money Laundering Bill," Reuters, June 16, 2001.
[51] Marta Srnic, "Russians Tackle Money Laundering," Bloomberg News, June 25, 2001; Svetylana Kovalyova, "Russian Government urges passage of anti-money laundering bill," Reuters, June 26, 2001.
[52] Canute James and Michael Peel, "Tax Havens Tighten Rules," *Financial Times*, June 17, 2001.
[53] See *Economist*, "Fighting the Dirt," June 21, 2001.
[54] Membership lists can be found at http://www1.oecd.org/fatf/Members_en.htm#OBSERVERS.

laundering. Through club IGOs like the G-7 and FATF, great powers were able to cajole, coerce, and enforce a global anti-money laundering standard into existence.

6. CONCLUSION

The process of creating and enforcing global financial regulation clearly follows a club standards model of global governance. In designing the content of global financial regulations, the great powers largely bypassed the IFIs. Instead, the G-7 created club IGOs – like the Financial Stability Forum – and empowered other club IGOs – such as the Basel Committee and the Financial Action Task Force – to ensure control over the establishment and enforcement of common financial standards. The G-7 countries then pushed to have the IFIs act as enforcement regimes for these new standards, with moderate success. Developing country IGOs, in contrast, had no influence over the setting of global financial standards, and were badly weakened from the financial crises and their aftermath (Narine 2002).

The normative and positive implications for the study of the global political economy are quite significant. Normatively, this paper's results suggest that correcting the "democratic deficit" and transparency of global economic governance will be significantly harder than is commonly understood. To NGOs, social movements, and anti-globalization protestors, the focal point for global economic governance has been the Bretton Woods Institutions (O'Brien *et al* 2000; Elliott *et al* 2003). Global civil society advocates particularly deride the "green room" process, in which key decisions are made by powerful states behind closed doors. However, the model of global governance presented here suggests that once the great powers achieve a concert on an issue, they will design governance structures that ensure the permanence of the green room. One obvious prediction of the theory presented here is that the more successful global civil society is at

democratizing the Bretton Woods institutions, the more that the great powers will rely on alternative IGOs to devise and enforce the rules of globalization.

Positively, the analysis suggests that the focus on the IFIs obscures much of the politics involved in the creation of global financial regulation. The important bargaining is done in club IGOs such as the G-7, OECD, Basle Committee on Banking Supervision, and Financial Stability Forum. It also suggests, consistent with the Rational Design approach to international organizations (Koremenos, Lipson, and Snidal 2001) that even when universal-membership IGOs are designated as the "lead" international agency, their unwieldiness leads the great powers to create new clubs in order to better control policy outcomes.

Theoretically, the model presented here suggests a greater emphasis on the role that forum-shopping plays in the development of global governance structures. Employing Benjamin Most and Harvey Starr's (1984) concept of substitutability makes it easier to understand why little progress has been made on the subject of globalization and global governance. Scholarship focusing on IGOs frequently treats all such organizations as the same type of actor.[55] This overlooks the extent to which IGOs differ by membership and organizational structure (Koremenos *et al*, 2002). Great powers will engage in forum-shopping to select the optimal IGO to advance their preferences. Scholars focusing on non-state actors tend to confuse visibility with effectiveness.[56] Activity by non-state actors may be relevant to the regulatory outcome, or may be epiphenomenal. Unless the distribution of interests and the substitutability of governance structures are taken into account, it will be impossible to develop a model of global governance that garners significant empirical support.

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[55] For example, Slaughter's (1997) discussion of transnational networks of regulators fails to distinguish between the Basel Committee and the universal IGOs.
[56] For empirical examples of this problem, see Graham (2000) on the MAI and Drezner (2004) on Internet governance.

Finally, the theory presented here highlights the need to focus more clearly on the origins of great power preferences in the global economy. The model presented here is a theory of process and outcomes, not a theory of preferences. The virtue of the process theory is that it identifies *which* actors' preferences are relevant – namely, the great powers. However, this realization leads to a question: what drives the preferences of relevant actors? How can we divine what governments want? These are daunting questions, and international relations scholars have been chary with answers. This is particularly true with regard to state preferences. As Jeffry Frieden (1999, p. 54) notes, "it must be admitted that we have few… ways of determining what a nation's preferences will be solely on the basis of a nation's properties." It is to this task that scholars of the global political economy must pursue with greater vigor.

TABLE 1
A TYPLOGY OF REGULATORY COORDINATION

Divergence of preferences among great powers		Divergence of preferences between great powers/developing states: **High conflict**	**Low conflict**
	High conflict	Sham standards	Rival standards
	Low conflict	Club standards	Harmonized standards

TABLE 2
ATTRIBUTES OF DIFFERENT REGULATORY SCHEMA

	Sham standards or no standards	**Rival standards**	**Club standards**	**Harmonized standards**
State strategies	Unilateral coercion and inducements	Competing standards; Schattschneider-style expansion of audience if losing	Great power concert; multilateral coercion and inducements	Functional optimization, delegation
Predicted solution	Weakly enforced standards; repeated conflict	Competing standards in multiple fora; great power opt-outs; unstable equilibria	Core-created and core-imposed standards	Technical standards
IGO role	Political cover; regional bodies significant	Competing arenas for bargaining	Coalition-building, standard-setting, strong monitoring/ enforcement role	Legitimation
NGO role	Lobbyists; norm promoters; substitute enforcers	Consensus-builders	Proselytizers; protestors	Standard-setters
Empirical examples	Greenhouse gases; labor standards	CFC emissions; whaling; GMOs	Money laundering; intellectual property rights	Product standards; Internet protocols

TABLE 3

THE TWELVE KEY FINANCIAL CODES AND STANDARDS

Subject area	Issuing body	Membership size (by country)	Type of organization
Monetary policy transparency	International Monetary Fund (IMF)	184	Universal IGO
Fiscal policy transparency	International Monetary Fund (IMF)	184	Universal IGO
Data dissemination	International Monetary Fund (IMF)	184	Universal IGO
Insolvency	World Bank	184	Universal IGO
Corporate governance	Organization for Economic Cooperation and Development (OECD)	30	Club IGO
Accounting	International Accounting Standards Board (IASB)	0	Private order
Auditing	International Federation of Accountants (IFAC)	0	Private order
Payment and settlements	Committee on Payments and Settlements Systems (CPSS)	11	Club IGO
Money laundering	Financial Action Task Force (FATF)	29	Club IGO
Banking supervision	Basle Committee on Banking Supervision	13	Club IGO
Securities regulation	International Organization of Securities Commissions (IOSCO)	102	Universal IGO
Insurance supervision	International Association of Insurance Supervisors (IAIS)	101	Universal IGO

TABLE 4

SUCCESS OF FATF THREATS OF ECONOMIC COERCION

Target country	Concessions to FATF	FATF response
The Bahamas	Complete acquiescence (Comprehensive anti-money laundering laws enacted and implemented)	Sanctions threat lifted (Removed from NCCT list)
Cayman Islands	Complete acquiescence (Comprehensive anti-money laundering laws enacted and fully implemented)	Sanctions threat lifted (Removed from NCCT list)
Cook Islands	Moderate concessions (Comprehensive anti-money laundering laws enacted; implementation plan in progress)	Sanctions threat suspended indefinitely
Dominica	Moderate concessions (Comprehensive anti-money laundering laws enacted; implementation plan in progress)	Sanctions threat suspended
Israel	Moderate concessions (Comprehensive anti-money laundering laws enacted; implementation plan in progress)	Sanctions threat suspended indefinitely
Lebanon	Moderate concessions (Significant anti-money laundering laws enacted; implementation plan in progress)	Sanctions threat suspended indefinitely
Liechtenstein	Complete acquiescence (Comprehensive anti-money laundering laws enacted and implemented)	Sanctions threat lifted (Removed from NCCT list)
Marshall Islands	Moderate concessions (Comprehensive anti-money laundering laws enacted; implementation plan in progress)	Sanctions threat suspended indefinitely
Nauru	Minor concessions (Incomplete anti-money laundering laws enacted)	Sanctions imposed in December 2001
Niue	Minor concessions (Incomplete anti-money laundering laws enacted)	Sanctions threat suspended
Panama	Complete acquiescence (Comprehensive anti-money laundering laws enacted and fully implemented)	Sanctions threat lifted (Removed from NCCT list)
Philippines	Minor concessions (Incomplete anti-money laundering laws enacted)	Sanctions threat suspended
Russia	Moderate concessions (Significant anti-money laundering laws enacted; implementation plan in progress)	Sanctions threat suspended
St. Kitts and Nevis	Moderate concessions (Comprehensive anti-money laundering laws enacted; implementation plan in progress)	Sanctions threat suspended indefinitely
St. Vincent and the Grenadines	Minor concessions (Incomplete anti-money laundering laws enacted)	Sanctions threat suspended

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