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# The End of an Era in International Financial Regulation? A Postcrisis Research Agenda

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**Abstract** The global financial crisis that erupted in summer 2007 has made the reform of international prudential financial regulation one of the top priorities of global public policy. Past scholarship has usefully explained the creation and strengthening of international financial standards with reference to three policy arenas: interstate, domestic, and transnational. Despite the accomplishments of this specialist literature, the recent crisis has revealed a number of limitations in the ways scholars have understood interstate power relations, the influence of domestic politics, and the significance of transnational actors within international financial regulatory politics. Taken together, developments in each of these three arenas suggest that researchers may also need to be prepared to shift from explaining the strengthening of official international standards to analyzing their weakening in the postcrisis world. The latter task will require scholars to devote more analytical attention to a wider set of international regulatory outcomes, including “informal regulatory convergence,” “regulatory fragmentation,” and especially “cooperative regulatory decentralization.”

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## Books Discussed in This Review Essay

- Drezner, Daniel W. 2007. *All Politics Is Global: Explaining International Regulatory Regimes*. Princeton, N.J.: Princeton University Press.
- Porter, Tony. 2005. *Globalization and Finance*. Cambridge, Mass.: Polity.
- Singer, David Andrew. 2007. *Regulating Capital: Setting Standards for the International Financial System*. Ithaca, N.Y.: Cornell University Press.
- Walter, Andrew. 2008. *Governing Finance: East Asia's Adoption of International Standards*. Ithaca, N.Y.: Cornell University Press.

The global financial crisis that erupted in summer 2007 has prompted politicians to declare the reform of international prudential financial regulation to be one of the top priorities of global public policy. As this issue has come to dominate the agenda of the newly created Group of 20 (G20) leaders summits and other international fora, scholars have scrambled to learn more about the political dynamics

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associated with this aspect of global economic policymaking. How does past scholarship on the politics of international financial regulation help us to understand the transformations triggered by the financial crisis in this area? Have recent developments revealed any limitations in the precrisis literature on this topic? What should be the future research agenda in the wake of the recent global financial crisis?

For more than two decades since the publication in 1989 in *International Organization* of Kapstein's pioneering work on the Basel Accord, scholarly attention has been focused on the goal of explaining the creation and strengthening of international prudential financial standards in the context of rapidly globalizing financial markets.<sup>1</sup> Theoretical scholarship on this topic tended to search for explanation and understanding within or across three particular policy arenas: interstate, domestic, and transnational. Seminal studies emphasized different actors and different political dynamics, as evidenced by four important books published just before the crisis. Drezner's *All Politics Is Global* focuses on the interests of, and exercise of power by, leading states as the primary driver of the creation of international financial standards. Singer's *Regulating Capital*, and Walter's *Governing Finance* analyze the interplay at the domestic level between regulators, elected policymakers, financial industry groups, and other societal actors. Porter's *Globalization and Finance* is concerned more with the influence of transgovernmental networks of regulators and transnational nonstate actors.

Despite the accomplishments of these books and the other past specialist literature, we argue that there is now a need for some serious rethinking within this scholarship. Theoretical innovation and new empirical research are required to address important limitations revealed by the crisis in existing understandings of interstate power relations, the influence of domestic politics, and the significance of transnational actors within international regulatory politics. Recent developments in all three policy arenas also suggest that researchers need to be prepared to shift from explaining the strengthening of official international standards to analyzing their weakening in the postcrisis world. The latter task will require scholars to explore a wider set of international regulatory outcomes, including "informal regulatory convergence," "regulatory fragmentation," and "cooperative regulatory decentralization." We suggest that a number of postcrisis trends are pointing in the direction of the last scenario in particular, and thus we encourage future researchers to devote more analytical attention to this regulatory outcome than they have in the past.

## Insights from the Precrisis Literature

The setting of international prudential regulatory standards has taken place in an incremental and piecemeal fashion since the mid-1970s alongside the globaliza-

1. Kapstein 1989. Some of the early literature was surveyed in prominent review essays during the mid-1990s that explored the causes and consequences of the globalization of finance; see Cohen 1996 and Andrews and Willett 1997.

tion of financial markets.<sup>2</sup> Early scholarly analyses of this process focused on the banking sector where the development of standards emerged first with the 1975 Basel Concordat concerning banking supervision and the 1988 Basel Accord that set common capital standards for international banks (subsequently updated with the negotiation of “Basel II” between 1998–2004).<sup>3</sup> More recent scholarship, such as the four books at the core of this review essay, has moved beyond the exclusive focus on banking. Singer compares the banking experience with efforts to create international capital standards in the securities and insurance sectors. Drezner and Walter focus on an even more ambitious initiative: the G7-led “international financial standards project” after the mid-1990s to promote the global adoption of international best-practice standards in those three sectors as well as others such as accounting, auditing, payments systems, and corporate governance.<sup>4</sup> Porter has an even wider focus that includes the creation of international standards relating to institutions such as hedge funds and credit-rating agencies as well as new financial products such as derivatives.

Although there is no consensus among these four authors about how to describe debates within existing literature, we believe their work and other past literature on this topic is best classified into three broad categories. Each category points to a distinct political arena—interstate, domestic, and transnational—as the source of the creation and strengthening of international financial standards. Analyses of the *interstate political context* explain international standards with reference to the exercise of power by dominant states. Drezner’s book is the most important recent analysis of this kind. Like Kapstein and most other analysts in this tradition, Drezner identifies relative market size as the key source of international power.<sup>5</sup> While the United States held the pre-eminent financial markets in the world for most of the postwar period, Drezner argues that the European Union (EU) has joined it as a second Great Power in recent years because of the size of its combined financial space.<sup>6</sup> By controlling access to their all-important financial markets, the United States and EU can secure foreign compliance with their preferred international regulatory outcomes.

In the case of the “international financial standards project,” Drezner shows how the United States and the EU initially used small “club” settings that they controlled to develop their set of new international standards. These settings included various international standard-setting bodies such as the Basel Committee on Banking Supervision (BCBS) as well as a new institution they created in 1999—the

2. For a description of this process, see, for example, Davies and Green 2008.

3. See Kapstein 1989 and 1994; and Oatley and Nabors 1998.

4. The G7 also encouraged compliance with IMF standards relating to macroeconomic policy and data transparency, a World Bank standard on insolvency and creditor rights, and recommendations of the Financial Action Task Force (FATF) relating to regulations to counter money laundering and terrorist finance.

5. See also Posner 2009; Simmons 2001; and Strange 1986.

6. See also Posner 2009.

Financial Stability Forum (FSF)—to coordinate the process.<sup>7</sup> Once the standards had been consolidated within these narrowly constituted settings, the dominant powers then promoted them globally, using market power as a key weapon. In addition to the threat of market closure to noncomplying states, Drezner argues that this power included indirect market power involving “communicating/publicizing national compliance with the relevant standards and codes to private-sector financial institutions and rating agencies.”<sup>8</sup>

If the exercise of power by dominant states helps to explain the creation of international standards, what explains the preferences of those states? While some power-centered analysts assume that dominant states are unitary actors pursuing various national interests, others have combined their focus on interstate politics with an opening of the “black box” to investigate the domestic sources of state preferences. Singer and Walter present the most detailed recent analyses to focus on the *domestic political context* as the primary source of international regulation.<sup>9</sup>

To explain why dominant states favor the creation of international standards in some circumstances and not others, Singer argues that it is necessary to study the preferences of the regulators who have traditionally led these international initiatives. Drawing on a principal-agent framework, Singer describes regulators as bureaucratic agents seeking to preserve their autonomy, prestige, and future job prospects by appeasing domestic legislative bodies (the principal). In order to achieve this goal, regulators attempt to balance the objectives of maintaining financial stability and of preserving the competitiveness of the influential national financial industry. In Singer’s model, a dual shock to both stability and competitiveness will create incentives for regulators to turn to international regulatory cooperation as a means to tighten domestic regulation without undermining the competitive position of domestic firms and markets. The latter is particularly sensitive to tighter regulations because of the highly mobile nature of financial activity. By exploring the different patterns of interaction between regulators and their respective legislatures and domestic industries during the past two decades, Singer provides an insightful explanation of diverse patterns of international regulatory coordination among leading states in the banking, securities, and insurance sectors.

7. Before 2009, the BCBS membership consisted entirely of developed countries (the G7 countries plus Belgium, Luxembourg, the Netherlands, Spain, Sweden, and Switzerland). The FSF’s country membership was initially restricted to the G7 but was expanded slightly a few months later to include Singapore, Hong Kong, Australia, and Netherlands. Switzerland was then added in 2007. The body also included representatives of the major international standard-setting bodies as well as international bodies such as the International Monetary Fund (IMF), World Bank (WB), Organization for Economic Cooperation and Development (OECD), Bank for International Settlements (BIS), the Committee on the Global Financial System, and the European Central Bank.

8. Drezner 2007, 139.

9. Drezner 2007 also argues that state preferences are strongly influenced by domestic politics, particularly the resistance of domestic private actors to adjustment costs associated with regulatory coordination.

Singer sees his approach as complementary to interstate power-oriented analyses. While his analysis accounts for why regulators in “core” states cooperate to create international standards, he argues that regulators secure the cooperation of more “peripheral” states through the flexing of power. By contrast, Walter presents a domestically oriented analysis that challenges this perspective. Through a detailed study of the experiences of Indonesia, South Korea, Malaysia, and Thailand, Walter argues that the degree of their compliance with the G7-led international financial standards project after the mid-1990s was largely a product of domestic politics rather than external pressures. In cases where compliance took place, he suggests that policy choices were usually driven more by domestic proreform interests. His more important point, however, is that there was considerable substantive noncompliance in many of these countries, particularly with respect to standards relating to corporate governance, accounting, and bank supervision where private-sector compliance costs were high and where third-party monitoring of compliance was difficult. In the face of strong domestic opposition, a kind of “mock” compliance emerged in these areas characterized by regulatory forbearance at the governmental level, administrative resistance, and private-sector noncompliance.

In analyzing compliance debates in these countries, Walter employs a broader conception of domestic political processes than Singer. While Singer focuses on the interaction between national regulators, elected policymakers, and financial industry groups, Walter explores the role of a wider range of actors who became involved in implementation debates, including proreform interests such as taxpayers and nongovernmental groups, and antireform groups such as nonfinancial firms and government ministries. Walter also moves beyond Singer’s assumption that private financial-sector preferences are uniform (that is, focused on international competitive concerns) in order to highlight divisions, such as those between weak banks that opposed reforms, and institutional investors and well-capitalized financial institutions that supported them. To explain resistance to compliance, Walter also draws more on institutional and structural factors highlighted in comparative politics literature such as the prevalence in East Asian capitalism of family-owned firm structures, bank-based financial systems (which left financial and nonfinancial interests more closely aligned), and developmental state structures.

A third and final approach to explaining international financial standards has focused on the *transnational political context*, notably the significance of transgovernmental networks and transnational nonstate actors that transcend the international/domestic divide. In the most significant analysis of this kind to date, Porter highlights the increasingly dense landscape of international institutions that has been created since the mid-1970s to address the regulation of global finance, such as the various international standard-setting bodies and the FSF. Many analysts who study the interstate and domestic political contexts argue that these institutions have little influence on international regulatory politics independent from the preferences and power of dominant states. Singer, for example, explains his skepticism: “[the institutions] are not constituted by treaty and are not granted agency—legal or otherwise—to act in international affairs. They have skeleton

staffs, often consisting of fewer than ten people, and generally exist to facilitate interaction among their members at scheduled intervals throughout the year.”<sup>10</sup> From Porter’s standpoint, however, these institutions’ role in cultivating informal transgovernmental networks of technocratic officials is significant for explaining the emergence of international standards.

Porter embraces a more constructivist perspective than Singer, arguing that the interests of regulators are shaped by their social interactions within these increasingly dense networks.<sup>11</sup> Like earlier work on transnational epistemic communities,<sup>12</sup> Porter suggests that the highly technical and practical nature of the discussions within the networks foster common knowledge and “shared understandings” among the officials involved, making the exercise of power politics and the pursuit of national interest less pronounced.<sup>13</sup> Because of the esoteric subject matter, discussions within these networks also take place largely outside the scrutiny of domestic politics, with legislative assemblies and governments rarely directly involved in, or aware of, their work.<sup>14</sup> Porter concludes that these transgovernmental networks “cut across the formal structures of states” and “display considerable autonomy from them,” thus echoing Slaughter’s broader case that transgovernmental regulatory networks are fostering cooperation by “disaggregating” states.<sup>15</sup>

Porter also highlights the role of transnational nonstate actors in international regulatory politics, above all financial industry groups.<sup>16</sup> Like other recent work in the transnationalist vein, he notes that the industry groups have become increasingly prominent in lobbying public regulators at the international level.<sup>17</sup> Private-sector actors have also been significant in directly assuming a regulatory role in international finance through the creation of private standards.<sup>18</sup> Such standards have been established by international industry associations (such as the Institute of International Finance or IIF), private institutions created specifically for standard-setting (such as the International Accounting Standards Board or IASB), and even individual financial exchanges (for example, the New York Stock Exchange), clearing houses (for example, the Clearing House Interbank Payments System or CHIPS), and firms (for example, Lloyd’s of London) that set rules on which global markets

10. Singer 2007, 34; see also p. 119.

11. For more recent constructivist work on international regulatory politics, see Abdelal 2007; Baker 2006; and Chwieroth 2009.

12. Kapstein 1992 explored the significance of the concept of transnational epistemic communities for studying bank regulators, but was ultimately cautious about its relevance because of cognitive disagreements at the technical level and because the officials remained embedded within domestic political settings and continued to serve various bureaucratic, national, and domestic interests.

13. Quoted in Porter 2005, 192. See also Porter 2003; and Porter 2005, 30, 43.

14. See also Porter 1993 and 2003.

15. Porter 2005, 43. See Slaughter 2004, which builds on Keohane and Nye 1977.

16. See also Scholte and Schnabel 2002; Germain 2004; and Mattli and Woods 2009.

17. See also Underhill and Zhang 2008.

18. See also Mügge 2006; Cutler, Haufler, and Porter 1999; Hall and Biersteker 2003; and Graz and Nölke 2008.

depend. Unlike state-centric analysts who exclude international standards created by the private sector from their analysis or explain them as the product of the preferences of Great Powers (United States and EU),<sup>19</sup> Porter argues that these standards have become a key feature of the international regulatory landscape. Porter also highlights how international public authorities have increasingly endorsed private standards in a number of sectors and have partially delegated the task of risk assessment to large international banks and credit-rating agencies within international banking regulation. The intense interaction between transnational networks of regulators and transnational private actors has led some scholars to conclude that international regulatory policymaking has been increasingly captured by transnational private financial interests.<sup>20</sup> Porter himself agrees that the influence of the transnational financial interests has been growing substantially in recent years, but he cautions that private interests do not always get their way.<sup>21</sup>

### **How the Crisis Has Challenged Understandings of All Three Contexts**

How well have these three broad approaches to the study of international financial regulation stood up to the experience of the recent global financial crisis? We argue that developments since the start of the crisis have revealed important limitations in the way the literature has analyzed all three political contexts. These limitations, in turn, suggest some important avenues for future theorizing and empirical work within each of the three arenas.

#### *Reconceptualizing Interstate Power Relations*

From an interstate perspective, the crisis has coincided with, and reinforced, a diffusion of power in global finance, thus challenging analysts to move beyond their past focus on the United States and the EU as dominant powers in international regulatory politics. In the late 1990s and early 2000s, developing countries were the main targets of the international standards project but they played little role in influencing the agenda of the United States and EU.<sup>22</sup> A decade later, China and other emerging powers within the developing world seized the opportunity of the crisis to demand a greater role in discussions about the future of international financial regulation to match their growing weight in global financial markets. Their new influence came less from the hosting of attractive financial markets than from the increasing significance in world markets of their investments and financial institu-

19. For the former, see Singer 2007, 8. For the latter, see Drezner 2007, 73–74.

20. See Underhill and Zhang 2008; and Claessens, Underhill, and Zhang 2008.

21. Porter 2005, 64–66, 103–4, 108–10, 115–16, 195.

22. Walter 2008.

tions. This significance was apparent at various stages of the crisis when cash-strapped U.S. and European institutions pleaded for financial support from investors and financial institutions from many of these “emerging-market” countries. The fact that many of these investors and institutions were state-owned (as in the case of sovereign wealth funds, central banks holding large reserves, or state-owned Chinese banks) only reinforced the power of their governments at that moment.<sup>23</sup>

U.S. and European recognition of their dependence on these new centers of wealth in the world economy helped pave the way for a widening of the “clubs” involved in international standard-setting. The demands of emerging powers for greater representation were initially met through the creation of G20 leader summits whose first meeting was focused almost exclusively on international regulatory issues and which immediately took over the role of agenda-setting in this policy area from the G7. With the encouragement of the G20 leaders, the membership of key international standard-setting bodies—such as the BCBS—was then quickly widened to incorporate more emerging powers from the developing world. The membership of the FSF was also expanded at the April G20 summit in London to include all G20 members, and this body was transformed into a more robust institution—the Financial Stability Board (FSB).<sup>24</sup>

These developments were important not just because they highlighted that international regulatory politics could no longer be viewed as what Posner calls the “Euro-American regulatory condominium.”<sup>25</sup> At a theoretical level, these developments also revealed the limitation of past scholarship’s focus on relative market size as the key source of power in international financial regulatory politics. International regulatory power can stem not just from the hosting of attractive financial markets but also from being the home country for internationally important investors and institutions. This different kind of “market power” of a number of emerging-market countries has, if anything, been augmented by the crisis. Investors and financial institutions from many emerging powers have weathered the crisis better than most American and European firms. Banks located in emerging-market countries have also taken advantage of the massive losses experienced by American and European institutions to climb the charts of the largest banks in the world (the three largest banks in the world in 2009 by market capitalization were Chinese).<sup>26</sup> This has given their home governments growing clout in international regulatory politics. Understanding the significance of this different kind of market power, and how it might be used in the coming years, needs to be an important subject for future research.

23. Chin and Helleiner 2008.

24. Helleiner, Pagliari, and Zimmermann 2009. Spain and the European Commission were also added as members of the new FSB at the time of its creation.

25. Posner 2009.

26. Michael Wines and Edward Wong, “An Unsure China Steps onto the Global Stage.” *New York Times* (online ed.), 1 April 2009, available at <http://www.nytimes.com/2009/04/02/world/asia/02china.html>, accessed 1 November 2010.



The crisis revealed one further limitation in precrisis conceptions of interstate power. Before the crisis, scholars focused primarily on “power-as-influence”; that is, how the hosting of important markets provided power to shape international rulemaking through changing the behavior of other countries. Since the start of the crisis, some flexing of power in international regulatory politics has had a different objective that is closer to what Cohen has called “power-as-autonomy.” Cohen describes this form of power as the capacity “to exercise policy independence—to act freely, insulated from outside pressure in policy formulation and implementation.”<sup>27</sup> This form of power has been particularly apparent in the EU’s regulatory response to the crisis. In addition to trying to influence the behavior of other countries through the G20 international regulatory discussions, European policymakers have acted unilaterally to reduce Europe’s dependence on, and vulnerability to, U.S. regulatory practices in a number of areas. They have flexed this “power-as-autonomy” by insisting that international private financial entities operating in Europe be subject to a greater degree of “host country control” by European regulatory authorities than in the past. This attempt to create what some commentators have called a “New Fortress Europe”<sup>28</sup> has been particularly apparent in the derivatives sector where an initiative is underway to force American derivative dealers to clear their EU contracts through a central counterparty located, regulated, and supervised in Europe for the first time. In the realm of the credit-rating agencies, European policymakers have also forced American rating agencies to have their ratings endorsed by a European subsidiary subject to European regulation.

Future theoretical work needs to explore the nature of this “power-as-autonomy” in international regulatory politics. Its importance has been apparent not just in Europe but also in emerging powers such as China. At the same time that Chinese investments and institutions are becoming more prominent within international markets, the country’s domestic financial markets are growing in size and diversity. Chinese domestic markets are hardly able to challenge New York or London in terms of their attractiveness to foreigners yet, not least because the Chinese government limits foreign access to them.<sup>29</sup> The growth of Chinese markets, in other words, is not boosting its power-as-influence in international regulatory politics. But it is reinforcing China’s power-as-autonomy by lessening the dependence of Chinese firms on U.S. and European markets. This growing ability to carve out an independent regulatory path can also be seen in other emerging countries such as Brazil and India whose domestic financial markets are increasing in size and sophistication. Whether officials in these countries take advantage of their rising capacity to adjust domestic regulatory policies without reference to the outside world and to withstand external pressures should be another future research topic. If policymakers do set down that route, their countries’ growing power-as-autonomy

27. Cohen 2006, 32.

28. Véron 2010.

29. Posner 2010.

may turn out to have an even more important impact on the trajectory of international regulatory politics than the power-as-influence gained through their new membership in the “clubs” that set international financial standards.

### *Changing Domestic Politics in Core States*

The crisis also revealed domestic political dynamics in leading advanced industrial countries that are difficult to reconcile with Singer’s model. **To begin with, the crisis challenged his assumption that “the main actors in international regulatory harmonization are regulatory agencies.”**<sup>30</sup> The severity of the crisis and the politicization triggered by massive bailouts of financial institutions in the United States and Europe put significant domestic pressures on elected policymakers in these core states to become directly involved in international regulatory politics. This was apparent in the way U.S. and European leaders used the G20 leaders process from November 2008 to lay out unprecedentedly detailed priorities and timetables for their own officials and international financial technocrats to follow.<sup>31</sup> **This development marked a striking reversal of precrisis trends, which Singer had (correctly) summarized in the following way: “the rules of global financial governance are increasingly the creation of international committees of regulators and private actors rather than heads of government acting in concert.”**<sup>32</sup>

The U.S. Congress and legislative bodies in Europe, especially the European Parliament, also influenced the direction of international regulatory change in a more direct way than simply threatening to curtail the autonomy of regulators (as in Singer’s precrisis model). The crisis triggered intensive legislative debates in the United States and Europe on previously obscure topics such as the regulation of credit default swaps or reforms to accounting standards, generating detailed legislative initiatives that in turn influenced the direction of international regulatory agreements. Members of the U.S. Congress even engaged in diplomatic missions to interact directly with members of the European Parliament on this issue.<sup>33</sup> The role of legislative bodies in shaping the direction of international reform was also enhanced by the ambition of the postcrisis international regulatory reform agenda that left regulators dependent on major legislative action at home to implement commitments reached internationally. This dependence has undermined Singer’s assumption drawn from the precrisis experience that “regulators who initiate international negotiations over harmonization do not face a ratification requirement and therefore can conduct themselves in a relatively opaque and seemingly

30. Singer 2007, 7.

31. Writing before the crisis, Singer 2007, 119, noted: “It is rare for heads of government to engage in direct discussions over the regulation of domestic financial industries.”

32. *Ibid.*, 124.

33. Ruth Sunderland, “US Takes Row Over EU Hedge Funds Directive to Brussels.” *The Guardian* (online ed.), 31 August 2009. Available at (<http://www.guardian.co.uk/business/2009/aug/31/US-hedge-funds-row>)

apolitical environment.”<sup>34</sup> These new direct roles assumed by leaders and legislators from leading countries in international regulatory politics require an in-depth understanding of the preferences of a wider set of public actors—leaders and legislators—toward international regulatory issues, as well as the domestic pressures they face.

The crisis has also challenged the way that many precrisis domestic-level analyses dealt with the role of domestic societal actors in shaping international financial regulation. Like other analysts, Singer highlighted how the range of domestic societal actors engaged in policy debates about international financial regulation was usually much narrower than in international trade or exchange rate politics because of the complexity of financial regulatory policies and their more indirect and less obvious costs and benefits. While Singer noted that financial crises generated domestic political pressure on legislators to act, his model does not explore the specific roles of societal actors beyond the financial industry in much detail. The recent crisis encourages scholars to focus more attention on the role and preferences of a broader range of domestic societal actors in core states. The politicization of financial regulatory issues during and after the crisis triggered the mobilization of corporate actors outside the financial sector as well as citizens’ groups, who found in the U.S. Congress and European Parliament new ways to influence U.S. and European positions toward international regulatory reform. We need more detailed knowledge of how the mobilization of these groups beyond the financial industry can influence the direction of state policy toward international regulatory standards indirectly through legislatures, as well as through direct lobbying of regulators and the executive branch.

The crisis also highlighted the limitations of models that depict the financial industry in leading powers as a cohesive group in regulatory debates with uniform preferences that stem from international competitive concerns. During the financial crisis, quite sharp divisions emerged among different parts of the private financial sector, divisions that reduced the sector’s overall influence. Banks demanded tighter regulation of credit-rating agencies against these agencies’ wishes. Accountants and banks strongly disagreed with each other about the need to reform market-to-market accounting. Investors and exchanges criticized the reluctance of derivatives dealers and brokers to accept tighter regulation of over-the-counter derivatives. In some cases, these divisions reflected efforts by individual sectors to shift the blame for the crisis and the regulatory burden upon other sectors. In other cases, certain parts of the financial industry recognized material gains they could realize from regulatory tightening in specific areas. The disagreements also reflected different lessons learned from the crisis and distinct judgments about the long-term interests of the financial industry. These developments suggest the need for future theorizing to disaggregate the industry into its constituent parts and to embrace more context-specific analyses of financial industry preferences.

34. Singer 2007, 119.

More detailed attention should also be devoted to the entire question of private “capture” of financial regulatory policymaking. Johnson has played a particularly important role in provoking debates on this topic with his argument that the crisis was caused in large part by the “river of deregulatory policies” sponsored by the private financial sector in the United States.<sup>35</sup> Johnson has argued that the financial sector’s disproportionate influence over regulatory policies came not just from campaign contributions but also from the prestige and cultural capital the sector amassed during the boom years as well as from the “revolving doors” between regulators and financial industry members that allowed the latter to have their preferences internalized in the policymaking process.<sup>36</sup> Britain’s top regulator, Lord Turner, has also talked about “regulatory capture through the intellectual zeitgeist” of the dominant belief among regulators in market efficiency during the years leading up to the crisis.<sup>37</sup> Other analysts have highlighted how regulators face particular pressures during financial booms not to rein in excessive financial growth from the financial industry and others who argue that “this time is different.”<sup>38</sup> This dynamic suggests the need for more cyclical theories of private influence in which booms encourage deregulation, followed by crises and reregulation.

One final area for future theoretical innovation relating to the domestic context in “core” countries relates to the diffusion of interstate power we described earlier. Like other prominent precrisis analyses of the domestic origins of international financial regulation, Singer models the relationship between independent regulators and their domestic political system drawing on the experience of advanced industrial countries. This approach was understandable when the United States and Europe were the principal dominant powers, but it is now more problematic given the growing influence of policymakers from countries whose domestic political context is often radically different.<sup>39</sup> For instance, the relationship between regulators, politicians, and financial industry groups is quite distinct in China where many of the most internationally active financial institutions are state-owned and regulators remain under more direct control of the executive.

35. Johnson 2009.

36. *Ibid.* Singer 2007, 22, also notes that the private financial industry is influential because it is “the source of generous campaign contributions and other forms of political support.” Writing before the crisis, Tsingou 2006 also highlighted how the complexity and dynamism of financial regulatory issues often left regulators dependent on private-sector expertise to keep abreast of financial market developments.

37. Quoted in “Roundtable: How to Tame Global Finance.” *Prospect Magazine* (online ed.), 27 August 2009. Available at (<http://www.prospectmagazine.co.uk/2009/08/how-to-tame-global-finance>).

38. Quoted from the title of Reinhart and Rogoff 2009. See also Warwick Commission 2009, 30; and Sheng 2009, 393. For a discussion of the new literature on capture, see Baker 2010.

39. Singer 2007, 32, acknowledges this limitation of his framework: “it is intended to be broadly applicable to any political environment in which a regulator is granted authority by a popularly elected body. Certain regulators are more insulated from political pressures than others, and not all regulators have the same scope or mandate. These sources of variation are deliberately overlooked by the model in exchange for a more general account of regulatory politics in an international context.”

The growing power of countries with quite different domestic political contexts highlights the need for more comparative analyses of the distinct domestic foundations of policies toward international financial regulation. Such analyses should address not just how national institutional arrangements influence state policy toward the design and implementation of international standards (for example, unitary versus federal political systems, single regulator versus different regulatory bodies etc.).<sup>40</sup> Equally important are more structural analyses that explore how attitudes toward international regulation are influenced by distinctive “varieties of capitalism.”<sup>41</sup> Some recent scholarship has pioneered this approach by showing how the different roles of the financial sector in Anglo-American liberal market economies versus Rhenish-coordinated market economies can help explain disagreements between these countries concerning the role of credit-rating agencies within the Basel II negotiations, the adoption of international accounting standards, and the regulation of hedge funds.<sup>42</sup> The global nature of the crisis provides analysts with particularly favorable conditions to advance this kind of comparative research agenda by exploring how this simultaneous shock has generated convergent or conflicting responses in different countries.

In sum, the crisis has reinforced the importance of the overall insight that Singer and others have developed about the centrality of domestic politics for international financial regulatory developments. But the crisis has also revealed new domestic political dynamics in core countries that suggest the need for adjustments to pre-crisis analytical models. Many of our suggestions here are in fact similar to points taken up by Walter in his study of compliance in peripheral countries. As noted, he analyzes a wider range of public and societal actors, identifies the differentiated preferences of financial industry groups, and embraces insights from comparative politics. The crisis has revealed how these approaches are now relevant also to the study of domestic politics within core countries with respect to both the setting of international standards and their domestic implementation.

### *New Constraints on Transnational Politics*

The crisis has also posed some challenges to the kind of transnationalist analytical framework put forward by Porter and others. To begin with, Porter and others in this tradition assume that transgovernmental networks operate quite insulated from their respective domestic political contexts and from interstate diplomatic pressures. These networks did demonstrate significant autonomy in the early stages of the crisis; indeed, it is striking how transnational regulatory bodies under the leadership of the FSF took the initial lead in formulating the comprehensive inter-

40. See Lütz 2004; Mattli and Büthe 2003; Davies and Green 2008; and Walter 2008.

41. For the broader literature on varieties of capitalism, see Hall and Soskice 2001. Drezner 2007, 41–43, also highlights the importance of national institutional histories and varieties of capitalism in exploring policy toward international regulatory issues.

42. See Baker 2006, 86; Wood 2005; and Perry and Nölke 2006.

nationally coordinated regulatory response that was endorsed at the first G20 leaders summit in November 2008.<sup>43</sup> But the ability of internationally networked technocrats to set the agenda soon became more constrained by the greater activism of the G20 leaders and legislative assemblies such as U.S. Congress and the European Parliament, which started to set detailed priorities and stringent deadlines for technocratic officials to meet.

The very feature of the networks that had been their strength before the crisis—their carefully cultivated autonomy—now became the subject of criticism from politicians who held the unelected international committees of technocratic officials at least partially responsible for the crisis.<sup>44</sup> Faced with newly engaged political leaders and resurgent domestic political pressures, transnational networks of financial officials were increasingly forced to react rather than to lead the international regulatory reform process. This development highlights the need for future research in the transnational tradition to theorize the ways in which transnational political processes are nested within the domestic and interstate political contexts.

The crisis has also challenged Porter's assumption that transgovernmental networks have a strong capacity to forge consensual technical knowledge. To be sure, this capacity was clearly on display right after the outbreak of the crisis when officials working within the FSF set the international agenda by reaching consensus on a detailed road map to strengthen existing international standards in various incremental ways. Even more impressive was the fact that by early 2009 they had developed a shared commitment to a new macroprudential regulatory philosophy that was aimed at preventing the accumulation of system-wide risk (as opposed to the microprudential focus of existing standards on protecting the stability of individual financial institutions, markets, and instruments). Since then, however, cracks in the ideational cement began to open, particularly vis-à-vis questions relating to the implementation of macroprudential objectives such as curtailing procyclicality in the financial system or developing differential treatment of "systemically important" institutions. Increasingly strong and public disagreements among financial officials from the leading powers eroded the cohesion, and thus the influence, of transgovernmental expert networks.

These disagreements partly reflected the growing external constraints on the autonomy of transgovernmental regulatory networks' emanating from domestic and interstate political contexts. But transgovernmental networks have also experienced challenges from within. The severity of the crisis badly shook confidence in the kinds of ideas and forms of knowledge around which technocratic consensus had formed during the preceding years. Walter documents in his book how the East Asian financial crisis of 1997–98 eroded the confidence of policymakers in that region and encouraged them to view and embrace an Anglo-American model

43. Helleiner and Pagliari 2009.

44. As Slaughter 2004 notes, the political vulnerability of transgovernmental networks comes from their uncertain accountability. See also Pauly 1997; and Baker 2009.

of “regulatory neoliberalism” as a superior model.<sup>45</sup> Because the post-2007 crisis originated in U.S. markets and quickly spread to the British financial system, the legitimacy of that model has been undermined and authorities from East Asia, continental Europe, and elsewhere have become more assertive in questioning U.S. and UK regulatory practices. In the absence of the old “intellectual compass,”<sup>46</sup> the task of creating a focal point around which the reforms of different national regulators can converge has become more difficult. Scholars working in the transnationalist tradition need to research and theorize the politics of consensus formation and knowledge generation within the transgovernmental networks in this new environment.

Future researchers also need to explore whether the difficulties in reaching and maintaining technocratic consensus may be exacerbated by the inclusion of new members from emerging powers within transnational groupings. The latter reform, driven by political imperatives within the interstate political context, has increased the intellectual diversity in these groupings. In the past, developing country officials often presented quite distinct perspectives on international regulatory issues.<sup>47</sup> These perspectives reflected not just development priorities but also the fact that their countries’ financial systems, regulatory arrangements, and traditions were often quite different from those of advanced industrial countries. Are the new members of the “clubs” of international standard-setting thus likely to challenge the ideas and knowledge developed by advanced industrial states within these bodies, or will the transgovernmental bodies instead socialize the new members into the worldviews of the existing membership? Similarly, the fact that officials from new member countries such as China are more directly under the influence of their government’s executive branch raises important questions about the capacity of transgovernmental networks to remain insulated from the exercise of power politics and the pursuit of national interest. Is their new membership further weakening the capacity of transgovernmental networks to remain autonomous? More generally, are emerging states as susceptible to being “disaggregated” in the way that transgovernmental network theory suggests?

A number of postcrisis developments are not easily reconciled with another important trend identified in the transnationalist analytical perspective: its focus on the growing power of transnational private interests in international regulatory politics. Faced with a crisis of such enormous scale, politicians seized back much of the regulatory authority they had delegated to private actors. Under attack for its unclear accountability, the poster child for “private authority” in international regulatory politics—the IASB—accepted public oversight of its activities for the

45. Walter 2008.

46. Gillian Tett, “Lost Through Destructive Creation.” *Financial Times*, 10 March 2009, 9.

47. For example, Porter 2005, 127, 134, notes developing countries’ dissatisfaction within the International Organization of Securities Commissions (IOSCO) of the dominant interpretations of the East Asian crisis during the late 1990s, as well as Chinese criticisms of the Basel Committee in the early 2000s.

first time in early 2009. G20 policymakers also committed to extending greater public control over those sectors where international regulatory responsibility had been delegated to the self-regulatory initiatives by transnational private actors before the crisis, such as over-the-counter derivatives, hedge funds, and credit risk management by banks. In addition, public authorities agreed to assume a greater role in monitoring and enforcing compliance in areas where these activities had previously been assigned to voluntary efforts, as in the case of credit-rating agencies. Lobby groups representing the international financial industry have opposed, but failed to stop, a number of these international regulatory reforms, as well as others such as the introduction of international standards on compensation.

The crisis has thus revealed how the power of transnational private actors is more contingent than some of the precrisis literature suggested.<sup>48</sup> Before the crisis, the close relations between transgovernmental networks and the transnational financial industry drove many of the precrisis international regulatory trends.<sup>49</sup> According to Tsingou, these elite officials and industry actors increasingly constituted a cohesive “transnational policy community” transcending the distinction between public and private, and dominating international financial regulatory politics.<sup>50</sup> As the crisis shifted the political action more to the domestic and interstate contexts, this community became, in Tsingou’s words, “under stress” and transnational private-sector groups found it less easy to capture the international regulatory agenda.<sup>51</sup>

Moreover, while the precrisis literature often depicted transnational private financial interests in monolithic terms, this crisis has revealed the emergence of sharp divisions among transnational financial industry. Some fault lines reflected the same kinds of conflicts noted above at the domestic level. But intra-industry conflicts at the transnational level were exacerbated by developments in the interstate and domestic political context. In the aftermath of the bailouts, policymakers pressured their national banks to strengthen their ties and redirect the provision of credit toward their home economy. The heightened awareness that global banks are global in life, but national in death (as the governor of the Bank of England Mervyn King put it) has complicated the efforts to forge a coherent transnational private-sector voice.<sup>52</sup> The ability of transnational private groups to remain a coherent transnational political force may also be weakened by the growing status of financial firms from emerging powers, especially China. While state-owned Chinese banks are now members of the IIF, the ambiguity of their status may inform their perspectives on international regulatory issues and align them more with those of public authorities in their home country.

We are not suggesting that international private financial interests have lacked influence in postcrisis international regulatory politics. As memories of the crisis

48. For an important exception, see Pauly 2003.

49. Underhill and Zhang 2008.

50. Tsingou 2006.

51. Tsingou 2009.

52. For King, see Financial Services Authority 2009, 36.



have begun to fade, transnational private-sector lobbies have also become bolder and more successful in their efforts to slow down and dilute many international initiatives to tighten regulation, often by exploiting policymakers' concerns about international competitiveness issues, and by highlighting the costs that regulation could impose upon the broader economy by stifling the recovery from the crisis. From the perspective of a number of observers, the enduring power of transnational private interests has been apparent in the fact that most international regulatory reforms today have been incremental rather than radical, even in the face of the worst global financial upheaval since the 1930s.<sup>53</sup> These developments have kept the debates about private "capture" politically salient at both the transnational and national levels, and they highlight once again the need for scholars to devote more serious theoretical attention to this issue.

### **Insights from a More Integrative Approach: Toward a Weakening of International Standards?**

These various limitations in the predominant understandings of the interstate, domestic, and transnational political contexts revealed by the crisis should encourage scholars to rethink the analytical toolkits they had developed prior to the crisis and adjust them to these new circumstances. At the same time, more effort should be devoted to the task of integrating insights from developments in all three of these political contexts. This integrative approach is fundamentally important for scholars inquiring about the future trajectory of international financial regulation in the postcrisis world. For more than two decades, scholarship concerning the politics of international prudential regulation has been focused on explaining the creation and strengthening of international standards. **When we examine post-crisis developments within the interstate, domestic, and transnational political arenas in an integrated way, the durability of this trend of ever-strengthening official international standards is called into question.**

One reason that the design of strong harmonized official international standards is likely to become more difficult in the coming years has to do with the diffusion of interstate power in international regulatory affairs. The fact that new powers have now been included within the most important international regulatory bodies is likely to make consensus harder to reach.<sup>54</sup> In addition to increasing the number of veto players, the diffusion of power may increase competition among Great Powers, and generate more possible focal points around which convergence could take place. The enhanced "power-as-autonomy" of many emerging powers could also reinforce these trends, as states acquire greater capacity to disregard external pressures to adopt international standards.

53. Tsingou 2009.

54. Levinson 2010, 85. See also Drezner 2007.

Some domestic-level developments also point to a possible weakening of international standards after the crisis. To be sure, faced with mounting domestic pressure to tighten regulation, regulators in the core countries have faced strong incentives to coordinate their actions for the reason Singer suggests: unilateral action by any one regulator could undermine the competitiveness of the domestic firms and markets in the regulator's country. International standards also help regulators to minimize the risks of negative externalities arising from poorly regulated jurisdictions abroad. But the wider domestic politicization of financial regulation triggered by the crisis has also complicated the task of arriving at international consensus as legislators, leaders, and a wider array of domestic societal groups have become more involved in regulatory debates.

The greater diversity in domestic political arrangements represented at the table of international standard-setting is also increasing the heterogeneity in regulators' preferences in ways that may hinder their capacity to commit to detailed harmonized international standards.<sup>55</sup> In addition, as the global shock is refracted through the imperatives of a greater number of "varieties of capitalism," the crisis may lead to increasingly uneven levels of implementation of international regulatory initiatives as well as unilateral moves by national authorities to preserve their distinctive domestic arrangements. The weakening of official international standards may be reinforced as regulators are prompted by the changed domestic political dynamics within the core powers to reduce their vulnerability to sources of risks outside their oversight. Support for greater "host country" regulation of international firms has been strengthened by episodes such as the failure of Icelandic authorities to regulate their banks abroad and the role of domestic authorities in the massive bailouts.<sup>56</sup> Greater reliance on host country rules may have the effect of forcing large international financial institutions to move in the direction of segmenting their business into a collection of separately capitalized national subsidiaries that are subject to distinct sets of rules.<sup>57</sup> In such a world, countries would have greater freedom to implement the national standards that they prefer.

These trends within the domestic and interstate political arenas may be reinforced by the weakening of the autonomy of transgovernmental technocratic networks. As discussed, officials within these networks may also encounter greater difficulties reaching consensus as the networks expand in size and heterogeneity. Furthermore, in the one area where a strong postcrisis consensus has emerged—macroprudential regulation—many of the new policy goals may push regulators away from detailed international harmonization. International initiatives to apply stricter regulation over systemically important institutions, for example, have quickly concluded that many international standards in this area are likely only at a very

55. Persaud 2010, 638.

56. *Ibid.*, 642.

57. See Pauly 2009; Persaud 2010; and Martin Wolf, "New Dynamics," *Financial Times* (online ed.), 6 November 2009, available at ([http://www.ft.com/cms/s/0/9177bcc6-ca69-11de-a3a3-00144feabdc0,dwp\\_uuid=494bcfb8-ca01-11de-a5b5-00144feabdc0.html](http://www.ft.com/cms/s/0/9177bcc6-ca69-11de-a3a3-00144feabdc0,dwp_uuid=494bcfb8-ca01-11de-a5b5-00144feabdc0.html)), accessed 1 November 2010.

general level of principles because “a high degree of judgment and flexibility to reflect national and conjunctural circumstances will inevitably be involved in the assessments” of which institutions fit in this category.<sup>58</sup> Other aspects of the macroprudential regulatory agenda may also encourage greater segmentation of global financial business along national lines. Initiatives to require systemically important financial institutions to establish “living wills,” for example, will likely to have the effect of forcing these firms to “ring fence” their global business in this way. The same consequence may flow from efforts to introduce countercyclical capital charges for banks. Because credit cycles vary by country, the BIS has noted that countercyclical capital charges “must be adjusted separately for each geographical portfolio held by an institution operating across national boundaries.”<sup>59</sup> For this reason, a number of analysts have concluded that countercyclical charges would most effectively be implemented simply on a host country basis.<sup>60</sup> The macroprudential agenda may thus reinforce the other trends that are pushing in the direction of a more “uneven playing field” in the international regulatory realm.<sup>61</sup>

Of course, a countervailing force may be the creation of the new FSB that is designed to strengthen the capacity of transgovernmental networks of regulators to coordinate and implement international standards. The FSB has been given a more robust structure than the FSF, including an enlarged secretariat, a full-time Secretary General, a permanent Steering Committee, and some standing committees. It also has an official charter that sets out obligations on members to undergo peer reviews and periodic assessments of the implementation of international financial standards by the International Monetary Fund (IMF) and World Bank. Some, such as U.S. Treasury Secretary Timothy Geithner, have even described the new organization in ambitious terms as “in effect, a fourth pillar” of world economic architecture alongside the IMF, World Bank, and World Trade Organization (WTO).<sup>62</sup> Whether this institution lives up to these expectations in the face of the pressures outlined earlier must be a central subject for research in this area.

One other countervailing force is likely to be the lobbying of transnational private interests who favor the international harmonization of standards. During the crisis, they have often opposed unilateral initiatives and other moves toward regulatory divergence since these measures could force them to split their global operations along national (or regional) lines and create inconsistent regulatory frameworks and duplicative requirements in different countries. As noted, however, their influence and coherence may be weakened in the postcrisis world.

It is obviously difficult to anticipate how these various trends in the interstate, domestic, and transnational political contexts will play out (see Table 1 for a sum-

58. FSB, IMF, BIS 2009, 4.

59. BIS 2009, 132.

60. See for example Brunnermeier et al. 2009.

61. Warwick Commission 2009. See also Gillian Tett, “Brazil Clips Wings of Banks Adept at Capital Flight.” *Financial Times* (online ed.), 26 November 2009. Available to subscribers at (<http://www.ft.com/cms/s/o/d1953bb4-da2a-11de-b2d5-00144feabd0c.html>).

62. U.S. Treasury 2009.

**TABLE 1. Determinants of international regulatory change, pre- and postcrisis**

|   | <i>Determinant of international regulatory change</i>                     | <i>Precrisis</i>   | <i>Postcrisis</i>   | <i>Anticipated impact on international standards</i> |
|---|---|--|---|--|
| <i>Interstate context</i>                 | Degree of power concentration   | Concentrated ("Euro-American regulatory condominium")                    | More multipolar with emerging powers from developing world  | Weakening  |
|   | Typology of power   | Power-as-influence from market size                                      | — Power-as-influence from market size as well as growing significance of emerging countries' firms and investments in world markets<br>— Power-as-autonomy from growing market size and diversity | Weakening  |
| <i>Domestic context in core countries</i> | Regulators' preferences   | Balancing stability and competitiveness of domestic firms                | Stronger domestic pressures to "fix" domestic regulation and reduce vulnerability to external risk  | Strengthening and weakening                          |
|   | Interest groups lobbying regulators and policymakers                      | Mainly financial industry  | Financial industry plus wider number of interest groups   | Weakening  |
|   | Role of elected policymakers (leaders, parliaments)                       | Indirect   | Direct  | Weakening  |
|   | Varieties of capitalism   | Liberal (dominant) and coordinated market economies (subordinate)        | Greater diversity of varieties of capitalism  | Weakening  |
| <i>Transnational context</i>              | Autonomy of transgovernmental networks of regulators                      | High   | Lower (pressures from elected leaders and legislatures)   | Weakening  |
|   | Veto players in transgovernmental networks of regulators                  | Low (narrow membership)  | Higher (inclusion of new members)   | Weakening  |
|   | Heterogeneity of preferences  | Low (like-minded nature of transgovernmental networks of regulators)     | Higher (new members have different regulatory models)   | Weakening  |
|   | Focus of transgovernmental networks                                       | Microprudential focus  | Micro and macroprudential focus   | Strengthening and weakening                          |
|   | Institutional coordination among transgovernmental networks of regulators | Medium (Financial Stability Forum, standard-setting bodies)              | Higher (creation of Financial Stability Board)  | Strengthening  |
|   | Influence of transnational nonstate actors                                | Strong (transnational regulatory capture/transnational policy community) | Weaker  | Weakening  |

mary). But they highlight clearly that scholars need to take more seriously at least the possibility of a weakening of official international standards in the coming years. The dominant focus of past literature on explaining the creation and strengthening of international standards made sense given “real world” trends before the crisis. Scholars of international financial regulation must now be prepared to focus on a wider set of possible international regulatory outcomes.

### *New Outcomes to Explain*

What kind of international regulatory outcomes would need to be explained in a world of weakening official international standards? A number of the books reviewed here note that international market pressures and ideational diffusion may still generate informal regulatory convergence even in the absence of deliberate intergovernmental efforts to create international standards.<sup>63</sup> Governments may be tempted to maintain a level regulatory playing field vis-à-vis other states to bolster the confidence of investors, to prevent mobile financial firms from shifting their activities to more attractive regulatory environments abroad, or to conform to what is regarded by markets as “best practices.” Porter also shows how the self-regulatory activities of private actors with transnational reach may lead to a convergence of practices despite the failure of international cooperation among national regulatory authorities.

But are these mechanisms of informal convergence strong enough to counteract the centrifugal forces we described which are pushing policymakers toward charting independent regulatory paths? Walter argues that the power of transnational market pressures to promote convergence varies across different sectors and should not be overstated.<sup>64</sup> The possibility that informal regulatory convergence could be driven by a process of ideational diffusion also seems much less likely in a world where the credibility of the precrisis regulatory model has been weakened and there is much less consensus on optimal regulatory models. Finally, we have suggested that transnational private actors are weaker and more divided now than in the precrisis period, thus making it less likely that they will be able to create a united front capable of filling growing gaps that may be left by governments in international standard-setting through private international rulemaking.<sup>65</sup>

If transnational market pressures, ideational diffusion, and private rulemaking capacity are less influential, then a world of weakening official international standards is more likely to be associated with regulatory divergence. The implications of greater regulatory divergence, and the ways it can be governed, represent an important avenue for theoretical inquiry that has not been adequately explored by the precrisis scholarship, which was inclined to equate regulatory divergence with

63. See also Simmons and Elkins 2004; Simmons 2001; and Cerny 1994.

64. Walter 2008.

65. Mügge 2006.

an unraveling of international cooperation. For instance, Drezner highlights how the absence of strong cooperation among Great Powers may generate either “rival standards” or “sham standards.” Singer provides examples of the former, while the latter is exemplified by Walter’s focus on East Asian “mock compliance” with the international standards project.

These analyses are important but a move away from strong official international standards need not necessarily be associated with the absence of intergovernmental cooperation. What about situations in which effective international cooperation is explicitly designed to facilitate the co-existence of divergent national or regional standards? Drezner comes closest to acknowledging this possibility when he states that regulatory cooperation does not automatically imply policy convergence but could involve “the mutual recognition of other national standards.”<sup>66</sup> In the post-crisis era, scholars need to give more serious attention to these kinds of outcome, particularly because they have become the subject of major debate within international policymaking circles.

In a widely discussed March 2009 article in *The Economist*, Rodrik argued forcefully for a new model of international regulatory cooperation along these lines. His case rested on a strong critique of the international standards project of recent years. In his view, the drive to create “one size fits all” global standards overlooked the fact that “desirable forms of financial regulation differ across countries depending on their preferences and levels of development.”<sup>67</sup> It was also imprudent because policymakers could easily “end up converging on the wrong set of regulations,” a possibility that the crisis appeared to have revealed very starkly.<sup>68</sup> Moreover, he questioned whether it was really politically realistic to expect that leading countries, such as the United States, would agree to “surrender significant sovereignty”<sup>69</sup> in international standard-setting processes.

In place of strong harmonized international standards, Rodrik advocated a “Plan B for global finance” that would place the choice and responsibility for financial regulation and supervision much more squarely at the national level (or perhaps regional level, in a case such as Europe). Global financial firms would be supervised by host country authorities and abide by host country regulations relating to such issues as leverage and capital standards. Rodrik acknowledged that the international financial order would thus become somewhat more segmented, but he argued that “an architecture that respects national diversity does more to advance the cause of globalisation than ambitious plans that assume it away.” This move away from strong international standards would not be a world without international cooperation. To prevent “adverse spillovers,” he suggested that countries would need to agree to “an international financial charter with limited aims, focused

66. Drezner 2007, 11.

67. Rodrik 2009.

68. Ibid. See also Levinson 2010.

69. Rodrik 2009.

on financial transparency, consultation among national regulators, and limits on jurisdictions (such as offshore centers) that export financial instability.” Regulatory arbitrage, in particular, would be dealt with by giving governments the “right to intervene in cross-border financial transactions—but only in so far as the intent is to prevent competition from less-strict jurisdictions from undermining domestic regulations.”<sup>70</sup>

The case for this more decentralized international regulatory order has been developed further by the Warwick Commission on International Financial Reform.<sup>71</sup> In addition to echoing Rodrik’s arguments against detailed global standards, the commission added the case that nationally distinctive host country regulations would greatly simplify the implementation of the new “macroprudential” countercyclical regulations that the G20 and FSB have endorsed,<sup>72</sup> and also enable developing countries to better tackle distinctive risks associated with currency mismatches or procyclical capital flows. The commission also noted that countries would be better insulated from the collapse of a parent bank abroad if international banks were forced to establish subsidiaries regulated by host governments.

Like Rodrik, the Warwick Commission argued that host country rules would need to be coordinated internationally at the level of common broad principles to address competitive pressures and externalities stemming from poor regulation abroad and to prevent the use of host country rules for protectionist purposes. International assistance would also be needed to boost the capacity of smaller and/or poorer countries that may lack sufficient capacity to implement effective host country regulation. Equally important would be the task of strengthening the capacity of all countries to regulate at the national level through cooperative research, early warning systems for global risks, and extensive information sharing (relating to market developments, activities of large firms, regulatory initiatives abroad). The commission suggested that the new FSB might be well positioned to support these various cooperative tasks.

One other blueprint for a model of international cooperation designed to allow a more decentralized international regulatory order has come from Eichengreen. Unlike the proposals of Rodrik and the Warwick Commission, Eichengreen’s plan would not rely on greater use of host country regulation. Instead, he suggests that an international organization “would establish principles for prudential supervision” but in a manner that allowed for national diversity. These principles would not “prescribe the structure of regulation in detail” and members would be able “to tailor supervision and regulation to the particularities of their financial markets.”<sup>73</sup> To prevent the “destructive spillovers of poor regulation,” Eichengreen

70. All quotes in this paragraph are from Rodrik 2009.

71. Warwick Commission 2009. See also Persaud 2010.

72. See also Brunnermeier et al. 2009.

73. Quoted in Eichengreen 2009, 18, 19. Other critics of detailed harmonized international rules who favor more principles-based international standards that allow for more national policy space include Bryant 2003; Tarullo 2008, 223, 265, 282–84; and Sheng 2009, 361.

suggests that countries could block access to their financial markets to institutions that were chartered in countries that did not meet the broad principles. Judgments about this could be made by “an independent body of experts, not unlike the WTO’s Dispute Settlement panels.”<sup>74</sup> Eichengreen notes that an advantage of this proposal would be that private institutions seeking to operate abroad would have a clear incentive to lobby for tighter regulations at home. To perform these various tasks, Eichengreen proposes the creation of a new “World Financial Organization” (WFO) but the FSB might also be well suited to assume these roles.

**TABLE 2.** *Typology of international regulatory outcomes*

|  | <i>Regulatory convergence</i>  | <i>Regulatory divergence</i> |
|--|--------------------------------|------------------------------|
| <i>Interstate cooperation</i>            | Strong international standards | Cooperative decentralization |
| <i>Absence of interstate cooperation</i> | Informal convergence           | Fragmentation                |

These proposals highlight that effective international cooperation need not always be associated with creation and strengthening of strong harmonized international standards. We can think instead of a wider range of international regulatory outcomes, as outlined in Table 2. Under this framework, four possible outcomes exist, according to variations in both the level of interstate cooperation and the degree of regulatory convergence. As noted, existing scholarship has highlighted how regulatory convergence can be a product of not just interstate cooperation (the upper left-hand quadrant) but also international market and ideational pressures or the self-regulatory initiatives of the private sector (the lower left-hand quadrant). In our view, however, the issue that deserves more attention from future scholarship concerns the options on the right-hand side of the table. If we are heading for a world of greater regulatory divergence, the key question is whether this takes place within a framework of strong interstate cooperation or not. The latter would result in a more fragmented international regulatory order of the kind that Drezner’s sham or rival standards describe (the bottom right-hand quadrant).<sup>75</sup> The former would represent what we might call a scenario of “cooperative decentralization” advo-

74. Quoted in Eichengreen 2008, 26.

75. It is also worth noting that a fragmented regulatory order need not be seen only in a negative light. If meaningful international regulatory cooperation cannot be achieved in the postcrisis era, Stiglitz argues that a unilateral strengthening of domestic regulation may be a “second best” policy but it is “far better than the third-best alternative of delayed and ineffective regulation;” Stiglitz, “Watchdogs Need Not Bark Together,” *Financial Times* (online ed.), 9 February 2010, available at (<http://www.ft.com/cms/s/0/3ebddd1e-15b7-11df-ad7e-00144feab49a.html>), accessed 1 November 2010.



cated by Rodrik's Plan B, the Warwick Commission, or Eichengreen's WFO (the top right-hand quadrant).

### *Theorizing Regulatory Divergence*

Under what political conditions is the scenario of cooperative decentralization likely to prevail over fragmentation? The answer will depend partly on the capacity of international regulatory bodies to facilitate that cooperation in the face of strong centrifugal political pressures. At first sight, these institutional capacities seem to be limited by the lack of a strong international organization with the power to monitor and enforce compliance among its members. The existing patchwork of transgovernmental regulatory bodies remains constrained by its loose network-based structures and weak enforcement mechanisms as well as the increasingly diverse membership of these bodies. The creation of the FSB has strengthened the structure of transgovernmental cooperation, but it has little formal power and acts more as a "network of networks" than a substantial international institution along the lines of IMF, World Bank, or the WTO.<sup>76</sup>

It is important to recall, however, that the institutional form that best facilitates international regulatory cooperation is not independent from the "content" of the cooperation being sought. The kinds of international cooperation required to sustain a scenario of cooperative decentralization are different from those supporting the creation of the strong harmonized international standards. While some assume that more international cooperation is inherently useful, advocates of cooperative decentralization highlight the benefits of scaling back the ambitious forms of cooperation that were embodied in the efforts to build strong official international standards. As Rodrik puts it, "the world economy will be far more stable and prosperous with a thin veneer of international co-operation superimposed on strong national regulations than with attempts to construct a bold global regulatory and supervisory framework."<sup>77</sup> According to the blueprints for cooperative decentralization outlined here, this "thin veneer of international cooperation" would be centered upon the development and promotion of broad principles-based international regulatory standards as well as activities such as information-sharing, research collaboration, international early warning systems, and capacity building. Network-based cooperation might suffice to sustain these more limited tasks since this "new internationalism" would not rely so heavily on detailed international commitments or enforcement<sup>78</sup> Indeed, networks may even have some advantages since scholars have often identified the facilitation of these kinds of activities as among the main strengths of this form of governance.

76. Porter (2007, 124) used the phrase "network of networks" to describe the FSF.

77. Rodrik 2009. See also Levinson 2010.

78. Quote from Persaud 2010, 643.

One other cooperative activity outlined by some advocates of “cooperative decentralization” involves the process of penalizing jurisdictions that do not abide by minimum international principles. Under Eichengreen’s proposal, an international institution would authorize the use of sanctions against such jurisdictions. Interestingly, the FSB has already moved quickly to assume this role, establishing a set of procedures that will allow its members to identify jurisdictions that are not complying with some international principles relating to cooperation and information exchange vis-à-vis the regulation and supervision of banks, securities, and insurance. Among many possible penalties for noncompliance is included the blocking of access to the FSB members’ financial markets. This initiative signals a willingness of FSB members to see the organization combine “soft” networked governance with the use of “hard” power or “hierarchy.”

While the FSB members are willing to enforce compliance collectively vis-à-vis small outsiders, scholars have noted that networked governance is less well suited to punish members of the network itself. As Eilstrup-Sangiovanni puts it, networks are defined by their lack of a “legitimate organizational authority to resolve disputes among actors.”<sup>79</sup> The FSB reveals this tendency as well. Its members have chosen to assign the FSB plenary the role of identifying noncomplying jurisdictions, rather than the kind of WTO-like dispute settlement panel that Eichengreen proposes. Because the plenary is governed by a consensus of all members, it is unlikely that sanctions would ever be applied against FSB member country. For the “insiders,” the pressure to comply will stem instead from softer forms of influence such as the new peer review process and periodic assessments of compliance with international standards by the IMF and World Bank. If those mechanisms prove insufficient to protect against poor regulation from other members, countries may be tempted to resort more to stronger host country regulation, either unilaterally (reinforcing the fragmentation outcome) or in a coordinated way, as suggested by Rodrik and others.<sup>80</sup>

Theorists thus need to consider seriously the hypothesis that the major international governance innovations emerging from the crisis are in fact pointing in the direction of the kinds of institutional capacities required to sustain a scenario of cooperative decentralization. While the crisis has not led to the emergence of a “World Financial Organization,” the creation of the FSB and the upgrade of the G20 grouping to the leaders’ level have strengthened the kind of network-based forms of governance—combined with the collective use of hard power vis-à-vis outsiders—which may in fact be suited to support the types of international cooperation necessary for that scenario.

In addition to these institutional capacity issues, the unfolding of a scenario of cooperative decentralization—as opposed to one of fragmentation—will depend also on the incentives that national regulators and policymakers face to cooperate.

79. Eilstrup-Sangiovanni 2009, 199.

80. See also Levinson 2010.

We have argued that the financial crisis has created new pressures and dynamics pushing these officials in the direction of carving out greater degrees of national (or regional) regulatory autonomy. At the same time, the incentives to cooperate remain strong because of the high level of global economic integration. Despite the deepest financial crisis in more than six decades, there are very few signs of a collapse of global economic interdependence and the emergence of rival closed economic blocs comparable to the 1930s. In this context, national officials are still drawn to international cooperation to address the risks of both competitive problems and negative externalities that can arise from poor financial regulatory practices in other countries. Even if they find it difficult to create strong international standards for the reasons we've noted, policymakers will still be tempted to mitigate these problems through looser forms of cooperation such as principles-based international standards, information-sharing, research collaboration, international early warning systems, and capacity building. As outlined, enduring global financial interdependence also creates strong internationally oriented private-sector constituencies at the domestic and transnational level which pressure policymakers to support cooperative arrangements over the fragmentation scenario because of fears that they could encourage protectionism and complicate their cross-border operations.

Future scholarship needs to be alert to the possibility that policymakers may increasingly embrace an international regulatory order centered upon cooperative decentralization as a means of reconciling these competing incentives for greater national (or regional) autonomy within the context of still-integrated global markets. This reconciliation would share some similarities with the "embedded liberal" compromise of Bretton Woods where policymakers sought to construct a multilateral open world economy that was compatible with the desire for national policy autonomy.<sup>81</sup> While the Bretton Woods architects pursued this goal in the context of rebuilding a world economy after the collapse of the 1930s, today's advocates of greater decentralization are responding to pressures for greater national policy space within an already-existing global economy. Ruggie described how the initial embedded liberal compromise was a product of U.S. power and a shared transnational social purpose of embedded liberal values that combined during the unique moment of the Bretton Woods negotiations of the early 1940s. In the current period, a movement from the top left-hand quadrant of strong international standards to the top right-hand quadrant of cooperative decentralization would likely be a more incremental and experimental process driven by efforts of policymakers, working within dense transgovernmental networks, to reconcile the competing incentives outlined above.

In exploring the likelihood of this scenario vis-à-vis fragmentation, scholars also need to be prepared for one additional possibility: variance in outcomes across different financial sectors. The strength of transgovernmental networks is not uni-

81. Ruggie 1982.

form across these sectors. The incentives pushing towards cooperative outcomes are not either. The intensity of cross-border competitive pressures, for example, is uneven from one part of the financial industry to another. Inadequate foreign regulatory practices also do not generate the same levels of negative externalities in all sectors. The cohesion and influence of transnational private financial groups is also not uniform across each segment of the financial industry. These differences helped to explain why the precrisis trend toward the strengthening of international standards varied across financial sectors. In a similar manner, they may influence whether a scenario of cooperative decentralization, rather than fragmentation, unfolds if international standards begin to weaken.

## Conclusion

The study of the politics of international prudential regulation is suddenly attracting more scholarly attention as policymakers prioritize international financial regulatory reforms in response to the recent global financial crisis. Fortunately, postcrisis scholarship on this topic need not start at square one; there has been a rich specialist literature during the past two decades analyzing the creation and strengthening of international prudential standards. Our analysis suggests that the crisis has revealed a number of limitations in the ways scholars have understood each of the three political arenas influencing international prudential regulation. Those concentrating on the interstate political arena need to address a power shift in finance revealed by the crisis and to conceptualize power in international regulatory politics more broadly than just in terms of “market size” and “power-as-influence.” The literature examining the domestic political sources of international financial regulation in “core states” should devote more attention to a wider set of public and societal actors, the complexity of the role of the private financial industry, and comparative perspectives. Transnationalist scholarship must recognize the limits of the autonomy and coherence of transgovernmental technocratic networks as well as of the power of private transnational interests.

Taken together, the developments revealed by the crisis within each of the three political contexts suggest that the crisis could represent a potential turning point for the initiatives that have been underway since the 1970s to build and strengthen international prudential standards. Supporters of these initiatives have hoped that they would make the globalized financial order increasingly shockproof. The post-2007 crisis dashed those hopes spectacularly, and it may, for the reasons outlined in the previous section, represent the highwater mark of the international standards project. If this turns out to be the case, the crisis would signal the end of an era in both the politics of international financial regulation as well as scholarship on this topic. Scholars would need to begin analyzing not the strengthening of international standards but their weakening in the coming years. Future theorizing would need to focus on the different international regulatory outcomes of informal convergence, fragmentation, and cooperative decentralization. In our view,

the last scenario is particularly deserving of more analytical attention not just because it has been so neglected in the past but also because a number of post-crisis trends point in its direction.

Addressing these various issues will require scholars of the politics of international prudential regulation to embrace a wider research agenda than they have in the past. At the same time, they will also need to do a better job at bringing out the broader implications of their subject for a wider nonspecialist audience. Before the crisis, the politics of international prudential financial regulation had attracted the attention of only a narrow group of specialists who were willing to immerse themselves in its highly technical details and often obscure initiatives. The crisis has revealed dramatically the enormous consequences that international prudential regulation has for the global economy as a whole. It has also highlighted the importance that the politics of international prudential regulation has had in influencing both the regulatory shortcomings that led to the crisis and the way out of the crisis. As the scholarly attention for this subject has grown significantly, it will be important for specialists of this topic to engage in more active dialogue with a broader range of scholars beyond their narrow subfield, including economists, and specialists in comparative political economy, and international political economy who study other sectors of the world economy.

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