Capital Rules

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This chapter, "Orthodoxy and Heresy," is the introduction to a book manuscript about the institutional foundations of global capital markets. Any comments and reactions are most welcome.

Chapter One

Orthodoxy and Heresy

> Il faut bien connaître les préjugés de son siècle, afin de ne les choquer pas trop, ni trop les suivre. (It is necessary to understand the prejudices of one's time, in order not to offend, nor to follow, them too much.)
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> — Charles-Louis de Secondat, Baron de Montesquieu

The rise of global financial markets in the last decades of the twentieth century was premised on one fundamental idea: that capital ought to flow across country borders with minimal restriction and regulation. Freedom for capital movements became the new orthodoxy. Any disputes were generally prejudged against governments and in favor of markets, the bearers of discipline. The International Monetary Fund (IMF) began informally to promote capital liberalization. The rules of the European Union (EU) and the Organization for Economic Cooperation and Development (OECD) obliged members, the world's richest thirty or so countries, to allow virtually all cross-border flows of capital. By the end of the 1980s, global finance was built upon and maintained by formal institutional foundations.

It was not always thus. Transactions routinely executed by bankers, managers, and investors during the 1990s – trading foreign stocks and bonds, borrowing in foreign currencies, for example – had been illegal in many countries only decades, and sometimes just a year or two, earlier. Circumventing such restrictions was possible, of course, but usually difficult and expensive. The rules of the international financial system written during the 1940s and 1950s had been restrictive by design and doctrine. At that time members of the international financial community collectively shared a set of beliefs about the destabilizing consequences of short-term, speculative capital flows, or "hot money," and the need for government autonomy from international financial markets.[1] To regulate and control capital was then the prevailing orthodoxy.

Subsequently, as the rules were liberalized, managers and investors enjoyed an era of extraordinary freedom. All sorts of transactions flourished. Perhaps most emblematic was foreign exchange trading, necessary for many cross-border capital flows and essentially non-existent in 1945. By 1973 the average daily turnover in foreign currency markets was $15 billion, then a nearly inconceivable sum. By 1998 $1.5 trillion changed hands each day in the markets. In 2004 the daily turnover was $1.9 trillion.[2]

The current era of global finance and attendant norms of openness to international capital are not without precedent, however. The heyday of the classical gold standard, circa 1870-1914, was similarly defined by liberal principle and practice. Policy makers understood that to restrict freedom of capital violated the rules, albeit unwritten, of the gold standard. Restrictions being neither normal nor legitimate, capital

[1] The origins of the expression "hot money" can be traced to a speech President Franklin D. Roosevelt gave in November 1936, the first time the phrase was used to describe financial flows. Previously the phrase had referred to marked bills received by gangsters, not to be spent for fear of getting arrested. See Jacques J. Polak, "Hot Money," unpublished manuscript, League of Nations, January 1943, p. 2, fn. 2.

[2] Bank for International Settlements, Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in 2004 (Basel: Bank for International Settlements, 2005).

was as free to flow from one country to another as it has ever been. Economist and statesman John Maynard Keynes once evoked the ease and seeming naturalness of the age by describing a London investor who might, by telephone, "adventure his wealth" around the world, buying shares of firms or bonds of municipalities all while "sipping his morning tea in bed."[3]

This thumbnail sketch of the history of capital controls suggests a number of important questions.[4] How and why did the world shift from an orthodoxy of free capital movements in 1914 to an orthodoxy of capital controls in 1944 and then back again by 1994? How are such standards of appropriate behavior codified and transmitted internationally? In this book I offer answers to these questions that diverge

[3] John Maynard Keynes, The Economic Consequences of the Peace (London: Macmillan, 1919), p. 11.

[4] Capital controls, government regulations on transactions that are recorded on a country's capital account in its balance of payments, include: unremunerated reserve requirements; taxes on international capital flows; limits on equity transactions; regulated interest rates for non-resident accounts; mandatory approvals for capital transactions; selective licensing of foreign direct investment; and prohibitions of financial inflows or outflows. Prudential regulations also influence transactions on the capital account. The distinction between capital controls and prudential regulations most often reflects whether they discriminate against international (as opposed to domestic) transactions: capital controls discriminate, whereas prudential regulations do not. The fifth edition of the IMF's Balance of Payments Manual introduced in 1993 a change in terminology that was adopted around the world. Most of the transactions previously measured in the "capital account" are now in the "financial account." Most economists, policy makers, and IMF officials continue to use the older terminology (i.e., to refer to current and capital, not current and financial, accounts), a practice I follow in this book. Thus, "capital account liberalization" and "capital liberalization" are here synonymous.

significantly from the scholarly literature on and conventional wisdom about the current era of globalization.

Conventional accounts of the rise of a new era of global finance and a liberal regime to govern it are so widely credited that they constitute truisms and starting assumptions for many scholars and policy makers. While I acknowledge substantial differences of emphasis, a synthesis would go something like this: The U.S. Treasury and Wall Street conceived and promoted a liberal regime for international finance because it served the interests of the United States. Ideological support for the movement away from regulation was provided by the rise of the Right and "neo-liberalism." The accumulation of scientific findings that capital liberalization promotes growth, in some versions of the "Washington Consensus," bolstered proponents' claims that a world of mobile capital would yield great benefits. Policy makers recognized that in an age of rapid technological change and well-articulated financial markets, capital controls "do not work." And governments were free to experiment with capital liberalization after the end of system-wide fixed exchange rates in 1971.

Each element of this familiar story, albeit plausible, is also in some way problematic (indeed, most warrant dismissal for lack of evidence), and collectively they comprise a wholly inadequate account. The alternative I propose in this book comes quite close to being opposite the prevailing explanation.

The most important misconception of the conventional account concerns the role of the United States. Undoubtedly, the United States played an important role in the creation of a world of mobile capital, through its agents in international financial markets (the public one, the Treasury, and the private one, Wall Street). Unilateral liberalization, bilateral pressure, crisis management, and massive flows of capital in both directions have put the country at the center of global finance. But neither the U.S. Treasury nor Wall Street has preferred or promoted multilateral, liberal rules for global finance. The U.S. approach to globalization has been neither organized nor rule-based, but rather ad hoc.

European policy makers conceived and promoted the liberal rules that compose the international financial architecture. The most liberal rules in international finance are those of the EU, and the United States was irrelevant to their construction. Nearly as liberal and almost as free of U.S. influence, the OECD's rules codifying the norm of capital mobility for developed countries mark another instance of European leadership and deliberate design. Europeans also conceived and embraced a proposal to codify in the IMF's charter a commitment to capital liberalization. The U.S. Treasury was indifferent to such an amendment and Wall Street entirely hostile. While a number of Europeans – and particularly the British, Germans, and Dutch – supported liberal rules for capital movements, three French policy makers in the EU, OECD, and IMF played crucial roles. The decisive confluence of worldviews was in Europe – in Brussels, London, Frankfurt, Amsterdam, and, most importantly, Paris. Europe did not merely acquiesce; Europe made financial globalization. Without an EU open to the world's financial markets – Europe's "open regionalism" – this era of global finance could not have emerged.[5]

The paradoxes do not end with the displacement of the United States by Europe in the story of the making of global finance. The disillusionment of the European Left, rather than the increasing power of the Right, led to the liberalization of capital movements in Europe, as well as to the codification of capital freedom in the rules of its common market. The Left was disillusioned, most profoundly in France, by the recognition that in an age of interdependence capital controls constrained only the middle classes. Socialists came to believe that capital controls "do not work" to prevent the rich and well-connected from spiriting their funds out of the country, but that they work all too well to lock up the bank accounts of their working- and middle-class constituents and voters. These processes took place in the absence of clear or systematic evidence that capital liberalization leads to improved economic performance. And capital became most free, and the rules most liberal, in Europe, where governments had fixed the exchange rates of their currencies intermittently since the 1970s and permanently in 1999 when the euro came into existence.

My account of the emergence of the rules of global finance, counter-intuitive in so many of its particulars, is based on these paradoxes. Refuting conventional wisdom is a daunting task under any circumstances, but when the evidence so convincingly

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[5] On "open regionalism," see Peter J. Katzenstein, A World of Regions (Ithaca, N.Y.: Cornell University Press, 2005).

demands it, the creation of an alternate explanation becomes a serious and necessary challenge. I resolve the paradoxes in this book by focusing on processes of social learning after financial crises, explaining the politics of international organizations, and demonstrating the consequences of codifying the boundaries of legitimate government policies. Most essential is to supplement the insights of the economists and political scientists who have written about the globalization of finance with the analytical tools of sociology and the perspective of history.

The End of the First Globalization, 1914-1944

The classical gold standard ushered in an era of unprecedented liberalism in the world economy. Although governments sometimes made exceptions and central banks often subtly manipulated the system, broadly speaking exchange rates were fixed, trade was free, and capital flowed smoothly from country to country. Even people moved across national borders with little interference. Firms and banks became multinational with relative ease. Governments were insulated from societal demands to reduce interest rates to stimulate domestic economic activity or raise them to cool off an overheating economy. Monetary policy was instead geared toward maintaining the value of the currency in terms of gold.

At the time these arrangements seemed natural. Keynes wrote eloquently of the sense of privilege a cosmopolitan enjoyed while traveling freely, and bearing gold and currency, across borders. Such a person, he observed,

> would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded this state of affairs as

> normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.[6]

Consensus on the essential rightness of the system was also extraordinarily widespread. Few respectable policy makers, and fewer still serious economists, would have dared suggest that the gold standard and its informal, unwritten rules of fixed exchange rates and free capital flows were inappropriate or undesirable. Although the political Left in Europe would later acquire a reputation for economic irresponsibility, the consensus was shared across the political spectrum. The gold standard, the so-called "money issue," was sacrosanct. The politics of the Right (associated with the orthodox economist David Ricardo) and the Left (symbolized by the Communist Karl Marx) had converged. "Where Ricardo and Marx were as one," Karl Polanyi wrote, "the nineteenth century knew not doubt."[7]

The practice of capital freedom broke down before the principle. The outbreak of the war in 1914 led the combatant governments to suspend the convertibility of their currencies into gold and, often, other currencies. Fixed exchange rates, international commerce, and cross-border investment collapsed – though only temporarily, most thought. In the early 1920s European governments sought in vain to reestablish on the same principle the pre-war system in political circumstances that were much changed.

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[6] Keynes, Economic Consequences of the Peace, p. 12.

[7] Karl Polanyi, The Great Transformation: The Political and Economic Origins of Our Times (Boston: Beacon, [1944] 1957), p. 25.

Europe's continental empires had disintegrated into successor states whose governments often carefully guarded their economic autonomy. The working classes, long disenfranchised, empowered the Left and politicized macroeconomic policy making for the first time. Factories had been destroyed, public finances ruined, and currencies debauched throughout the continent. Germany, severely punished by the economic and political terms of the Treaty of Versailles (1919), struggled to make a success of the fragile Weimar Republic. And the United States withdrew into isolation. Conditions could hardly have been less conducive to the reconstruction of the liberal pre-war order.

The onset of the Great Depression in 1929 unraveled all of the international links by which the world economy had once flourished. The decisive blow to the principle of capital freedom was the financial crisis of 1931-1933, which began in Austria in the spring of 1931 and spread throughout Europe. As the crisis threatened their banking systems and exchange-rate commitments, governments throughout Europe again took recourse to their wartime capital controls. More important, the crisis, coming as it did at the end of a decade of unstable international currency markets and huge, rapid flows of capital from one country to another, undermined policy makers' trust in unregulated financial markets. If the financial crisis represented the discipline of the market, governments concluded that their financial punishments far exceeded their modest fiscal and monetary transgressions.[8]

When American and European policy makers began to debate the rules by which the international economy ought to be reconstructed they agreed with their forebears that exchange rates should be fixed and trade free. Regarding capital, however, they would embrace a new principle.

Embedding Liberalism, 1944-1961

The post-war consensus on regulating capital was opposite the nineteenth century's validation of capital mobility. The newly formulated principle was to preserve the existence of markets by taming their social consequences, thereby preempting societal demands to destroy them altogether. Policy makers were keenly aware that such demands had undermined international cooperation in trade and money during the 1920s and 1930s. John Gerard Ruggie describes this reconciliation of markets with the values of social community and domestic welfare as the "embedded liberalism

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[8] Paul Einzig, Exchange Control (London: Macmillan, 1934), chapter 6. Also see Harold James, The End of Globalization: Lessons from the Great Depression (Cambridge, Mass.: Harvard University Press, 2001); and Maurice Obstfeld and Alan M. Taylor, "The Great Depression as a Watershed: International Capital Mobility in the Long Run," in The Defining Moment: The Great Depression and the American Economy in the Twentieth Century, ed. Michael D. Bordo, Claudia Goldin, and Eugene N. White (Chicago: University of Chicago Press, 1998). On the rise, fall, and rise again of globalization and the influence on multinational firms, see Geoffrey Jones, Multinationals and Global Capitalism: From the Nineteenth to the Twenty-First Century (Oxford: Oxford University Press, 2005), chapter 2.

compromise." Markets were to be "embedded" in social and political relations, rather than exist beyond them.

Capital controls were understood to be essential to the success of embedded liberalism.[9] Policy makers sought to encourage long-term, "productive" capital and regulate tightly short-term, "speculative" capital. Short-term capital movements not only constrained the autonomy of governments, but tended to be "disequilibrating," in

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[9] John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," International Organization, vol. 36, no. 2 (1982), pp. 379-416; and Ruggie, "Embedded Liberalism and the Postwar Economic Regimes," in his Constructing the World Polity: Essays on International Institutionalization (New York: Routledge, 1998), especially p. 74. On the decidedly non-liberal policy consensus see G. John Ikenberry, "A World Economy Restored: Expert Consensus and the Anglo-American Post-War Settlement," International Organization, vol. 46, no. 1 (1992), pp. 289-321; and Ikenberry, "Creating Yesterday's New World Order: Keynesian 'New Thinking' and the Anglo-American Post-War Settlement," in Ideas and Foreign Policy, ed. Judith Goldstein and Robert O. Keohane (Ithaca, N.Y.: Cornell University Press, 1993). On the institutionalization of this compromise in European polities, see Peter J. Katzenstein, Small States in World Markets (Ithaca, N.Y.: Cornell University Press, 1985). And on the place of capital controls in the embedded liberal compromise, see Eric Helleiner, States and the Reemergence of Global Finance (Ithaca, N.Y.: Cornell University Press, 1994), p. 4ff. and chapter 2; Barry Eichengreen, Globalizing Capital: A History of the International Monetary System (Princeton, N.J.: Princeton University Press, 1996), pp. 3-4 and 93-94; Harold James, International Monetary Cooperation Since Bretton Woods (Washington, D.C.: IMF; and Oxford: Oxford University Press, 1996), pp. 37-39; Jonathan Kirshner, "Keynes, Capital Mobility, and the Crisis of Embedded Liberalism," Review of International Political Economy, vol. 6, no. 3 (1999), pp. 313-337; Kirshner, "The Inescapable Politics of Money," in Monetary Orders, ed. Kirshner (Ithaca, N.Y.: Cornell University Press, 2003), pp. 4-5; Kathleen R. McNamara, The Currency of Ideas: Monetary Politics in the European Union (Ithaca, N.Y.: Cornell University Press, 1998), chapter 4; and Beth Simmons, "The Internationalization of Capital," in Continuity and Change in Contemporary Capitalism, ed. Herbert Kitschelt, Peter Lange, Gary Marks, and John D. Stephens (Cambridge: Cambridge University Press, 1999), pp. 37-38.

the policy idiom of the time. Economists and policy makers also worried about "self-aggravating" flows of capital that could, even in a country without problematic fundamentals, incite and exacerbate a financial crisis. Having emerged informally, this new consensus was at first, like its predecessor, unwritten.

Policy makers then wrote the consensus into the institutional architecture of the international monetary system. The rules were codified in three international organizations: the IMF, the European Community (EC), and the OECD. In each organization the debate about capital's freedom focused on the undesirability of "hot money" flows. The right of IMF, EC, and OECD members to regulate movements of capital, and especially short-term capital, across their borders was protected by the IMF's Articles of Agreement (1945), the EC's Treaty of Rome (1957), and the OECD's liberally named Code of Liberalization of Capital Movements (1961).

Accompanying this legal right was the collective expectation that capital controls would be normal and legitimate for the foreseeable future.[10] As John Maynard Keynes, one of the authors of the IMF's Articles, explained with typical elegance to the House of

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[10] Among many possible examples, see, especially, Economic, Financial, and Transit Department, League of Nations, International Currency Experience: Lessons of the Inter-War Period (Geneva: League of Nations, 1944); Ragnar Nurkse, Conditions of Monetary Equilibrium, Princeton Essays in International Finance, no. 4 (1945), pp. 2-5; Arthur I. Bloomfield, "Postwar Control of International Capital Movements," American Economic Review, vol. 36, no. 2 (1946), pp. 687-709, especially p. 687; Richard N. Gardner, Sterling-Dollar Diplomacy (Oxford: Clarendon, 1956), p. 76; and Richard N. Cooper, The Economics of Interdependence: Economic Policy in the Atlantic Community (New York: McGraw-Hill, 1968), p. 27.

Lords: "Not merely as a feature of the transition, but as a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements. What used to be a heresy is now endorsed as orthodox."[11]

Ad Hoc Globalization, 1961-1986

During the 1960s managers, investors, and speculators creatively began to find their way around the myriad regulations designed to constrain their practices. Although some of this creativity expressed itself illegally, through outright evasion, much of it took advantage of the invention of the Eurocurrency markets. Eurocurrency markets, ambiguously named, consisted of transactions based in currencies other than that of the host country. The quintessential Eurocurrency transaction was in London, where the market flourished most; Eurocurrencies were primarily Eurodollars. (So, for example, a German firm might issue dollar-denominated bonds in London.)

The Eurocurrency markets burgeoned also because the U.K. government permitted them in London. Although the United Kingdom had at that time an extensive capital controls regime, the Eurocurrency markets were allowed to operate almost completely without regulation.

The U.S. government also tolerated that managers of multinational American firms were, by conducting transactions in the Eurocurrency markets, violating the spirit

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[11] John Maynard Keynes, "Speech to the House of Lords, May 23, 1944," in The Collected Writings of John Maynard Keynes, ed. Donald Moggridge, vol. 26, Activities, 1941-1946: Shaping the Post-War World: Bretton Woods and Reparations (London: Macmillan; Cambridge University Press, 1980), p. 17.

of U.S. capital controls. The United States instituted in 1963 the interest-equalization tax to eliminate the incentive to take advantage of higher returns abroad. Along with voluntary controls on capital outflows, U.S. policy was designed in principle to avoid some of the transactions that occurred with increasing regularity through the 1960s.[12]

The pace of financial internationalization increased over the course of the 1960s. The Eurocurrency markets represented the ad hoc evolution of international capital markets. The rules of the system remained non-liberal, and no sovereign state, nor any international organization, stepped forward to govern global finance. These early indications of the direction of globalization emerged from the market participants with the tacit approval of the United States and the United Kingdom. Both governments came to embrace the globalization of finance not by reconsidering the multilateral rules, but by unilaterally liberalizing implicitly and explicitly.[13]

The markets that resulted soon wrought havoc on the entire multilateral system of fixed exchange rates. The increasing ability of financial market participants to move from one country (and currency) to another was fundamentally incompatible with an international monetary system designed around fixed exchange rates and autonomy for central bankers to manage domestic interest rates. Although a concatenation of events ultimately undermined the system of fixed exchange rates in August 1971, when the

[12] See Helleiner, States and the Reemergence of Global Finance, chapter 4.
[13] Helleiner, States and the Reemergence of Global Finance, p. 99.

United States suspended the convertibility of dollars into gold, many fingers were pointed at the widely denounced "currency speculators."

As the United States and the United Kingdom unilaterally liberalized capital flows during the middle and late 1970s, financial internationalization grew further. Even sovereign governments, for the first time since the 1930s, began systematically to tap international financial markets – and particularly the vast U.S. investing public.

Sovereign bond markets also evolved without a change in the formal rules of the system. Yet market participants quickly came to accept, even to acclaim, the authority of the credit rating agencies, particularly Standard & Poor's (S&P) and Moody's, as judges of the creditworthiness of governments. The influence of S&P and Moody's derived in part from the information content of their ratings, but also from the widespread incorporation of credit ratings into national financial regulations. The United States in particular increasingly delegated regulatory responsibilities to the agencies by using their ratings as benchmarks for the public's exposure to credit risk. S&P's and Moody's sovereign ratings thus carry the force of law in the United States and, today, in many countries around the world. The agencies' sovereign ratings, moreover, indirectly affect every other bond rating in the world because of the so-called "sovereign ceiling": the agencies almost never rate a domestic firm's foreign-currency debt higher than that of its government.[14]

The rating agencies' interpretive frameworks – their sense of and attempt to mirror the prevailing orthodoxy of the markets – have significant consequences, but their authority to govern international financial markets is not codified in any treaty or international agreement. By the middle of the 1980s the rating agencies began to interpret capital controls as unorthodox and governments that employed them as riskier borrowers. S&P managers at the time wrote of the critical importance of a "country's degree of political and economic integration with other 'Western' nations."[15] S&P analysts observed that although developing countries have "extensive capital controls," developed countries are more deeply integrated into international financial markets.[16] Over time, and subtly, the emerging orthodoxy represented and reinforced by the rating agencies increasingly rejected capital controls and embraced liberalization.

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[14] Timothy J. Sinclair, The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness (Ithaca, N.Y.: Cornell University Press, 2005). On sovereign ratings see Rawi Abdelal and Christopher M. Bruner, Private Capital and Public Policy: Standard & Poor's Sovereign Credit Ratings, Harvard Business School Case 705-026 (2005).

[15] Philip S. Bates and William J. Chambers, "Sovereign Policy Update: Denmark," Standard & Poor's International CreditWeek, December 1986, p. 16; and Bates and Chambers, "Offshore Domestic Currency Debt," Standard & Poor's International CreditWeek, May 25, 1987, p. 6.

[16] Helena Hessel and Philip S. Bates, "Comparing Countries' External Positions," Standard & Poor's International CreditWeek, May 25, 1987, p. 3.

The dominance of S&P and Moody's epitomized this ad hoc globalization, an internationalized finance without multilateral rules.[17] U.S. policy makers tended to welcome the growing influence of these distinctly American firms, empowered by U.S. laws, propagating and diffusing credit practices well-suited to U.S. economic institutions and familiar to U.S. investors. But the United States had no intention of formalizing the role of these firms at the center of the international financial system, and no other countries formally agreed to their predominance.

Rewriting the Rules, 1986—

Even as the legal rules of the system remained non-liberal for decades, a new era of global capital was in the making. By the middle of the 1980s, four states, the United States, the United Kingdom, Germany, and Japan, had liberalized capital flows across their borders. American, British, German, and Japanese banks and firms began to operate in financial markets that were no longer national, but also not yet global.

The unwritten rules of the international monetary system continued to evolve. Policy makers and bankers within these four states began to anticipate an informal trend toward the liberalization of capital by other governments. International financial markets were growing beyond national laws and domestic social norms; the

[17] Christopher M. Bruner and Rawi Abdelal, "To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy," Journal of Public Policy, vol. 25, no. 2 (2005), pp. 191-217.

compromise of embedded liberalism was unraveling.[18] Capital controls, once orthodoxy, were, according to a growing number of policy makers, becoming heretical again.[19] The internationalization of finance proceeded, but unevenly. Most governments continued to restrict capital flows, and those that had liberalized were free to reverse course.

Liberal Rules for European and Developed Countries

Two of the formal institutions of the international monetary system were remade at the end of the 1980s. The only partially liberal rules of the EC and OECD, which had slowed down the progress toward global financial markets, were revised to embrace a liberal financial system fully. By that time the EC's and OECD's rules obliged members to liberalize almost all foreign direct investment, but short-term, portfolio capital movements were still excluded. Hot money remained officially untrustworthy.

Then a 1988 directive issued by the ministerial Council, Europe's main decision-making body, obliged EC members to remove all restrictions on the movement of capital

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[18] See Kirshner, "Keynes, Capital Mobility, and the Crisis of Embedded Liberalism," pp. 326-328. For the best study of the decline and fall of embedded liberalism see Mark Blyth, Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century (Cambridge: Cambridge University Press, 2002).

[19] Benjamin J. Cohen, "Capital Controls: Why Do Governments Hesitate?" in Debating the Global Financial Architecture, ed. Leslie Elliott Armijo (Albany: SUNY Press, 2002), p. 104ff.; and Cohen, "Capital Controls: The Neglected Option," in International Financial Governance Under Stress: Global Structures versus National Imperatives, ed. Geoffrey R. D. Underhill and Xiaoke Zhang (Cambridge: Cambridge University Press, 2003).

among member states, as well as between members and non-members.[20] France, Germany, and the European Commission were, as always, essential to this major new initiative in European integration. The French government had blocked every attempt to liberalize capital within Europe for more than twenty years. Without a reversal of the French position the directive would have been impossible.

Not only were French Socialists disillusioned with the perverse distributional consequences of capital controls that no longer constrained the rich, but they also came to recognize that monetary union promised greater influence for France in a European economy dominated by the German mark and central bank. In the place of a Bundesbank governed by a dozen German central bankers the French envisioned a European central bank governed by a dozen European policy makers, of whom only one would be German and at least one would be French. The former French finance minister Jacques Delors, in concert with a number of other French policy makers, "decided that it would be better to live in an EMU zone than in a Deutsche Mark zone."[21]

The Germans, for their part, had long sought to make capital liberalization central to the European project. Europe's drive toward capital freedom constituted a quid pro quo: French acceptance of capital freedom for the German promise of monetary union. The Germans also insisted on the erga omnes principle for European capital

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[20] The liberalization obligations of the 1988 directive were further institutionalized in the 1991 Treaty on European Union, often referred to as the Maastricht Treaty.

[21] Author's interview with Jacques Delors, Paris, December 2, 2004.

liberalization: all capital flows, no matter the source or direction, would have to be liberalized. The erga omnes principle, according to Bundesbank President Karl Otto Pöhl, "was absolutely a prerequisite for monetary union. Germany never would have agreed to a single currency area with the possibility of capital controls on third countries."[22] For German policy makers the principle of erga omnes was connected to their commitment to the absolute "depoliticization" of money. Full convertibility removes the temptation, and the possibility, for authorities to serve "other political aims" by influencing the monetary system.[23]

This bargain between France and Germany was conceived and brokered in Brussels, the home of the European Commission. Two French policy makers, Jacques Delors, then president of the Commission, and his chief of staff Pascal Lamy, played decisive roles in the codification of the norm of capital mobility in Europe. Not only did Delors and Lamy propose the plan for capital liberalization and monetary union, but the French government would never have agreed to the bargain without the knowledge that Delors himself, a prominent French Socialist, had weighed the trade-offs. Brussels thus became the source of the most liberal set of multilateral rules of international finance ever written. The financial integration of Europe entailed, as a matter of European law, Europe's embrace of the internationalization of finance.

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[22] Author's interview with Karl Otto Pöhl, Frankfurt, June 29, 2005.

[23] See Hans Tietmeyer, "The Euro – A Denationalized Currency," in his The Social Market Economy and Monetary Stability (London: Economica, 1999), p. 215.

In 1989 the OECD's Code of Liberalization of Capital Movements, which had previously excluded short-term capital flows, was amended to oblige members to liberalize virtually all capital movements. As had been true for the EC in 1988, the amendment became possible only when the French government dropped its opposition to such a sweeping legal obligation to liberalize. Another French policy maker and Socialist, Henri Chavranski, was essential to the emergent consensus. Chavranski chaired during the critical years between 1982 and 1994 the OECD's Committee on Capital Movements and Transactions (CMIT), which oversaw amendments to and members' compliance with the Code of Liberalization. The United States, as an OECD member, was of course involved in these negotiations, but the impetus again had come from European, particularly French, German, Dutch, and British, policy makers.

For EC and OECD states such as Germany and the United Kingdom these new rules merely codified an obligation to continue to be liberal, a sort of ratification of choices their leaders had already made. But it took several years of entreaties and demands from Brussels and Paris to coax other states such as Italy and Greece to join their peers.

The new rules exerted their most profound effect in negotiations with prospective members. The privileges of membership being contingent on meeting the liberal standards articulated in the rules, the six countries that joined the OECD between 1994 and 2000 and the ten that joined Europe (renamed the European Union, or EU, by the 1991 Maastricht Treaty) in 2004 liberalized capital flows quickly and comprehensively. In 2005 the liberal rules of the EU and OECD governed some 70 to 80 percent of the world's capital flows, which were concentrated among these organizations' overlapping memberships of, respectively, 25 and 30 countries. Global finance had become an affair primarily of rich countries.[24]

Liberal Rules for All?

The last non-liberal rule was potentially the most consequential for patterns of openness and closure in international finance. The IMF's Articles of Agreement apply to nearly every sovereign state in the world, 184 in all. The Articles endow the IMF with a legal mandate to promote trade, but not capital liberalization; and although the Fund has jurisdiction over the current account restrictions imposed by its members, it has no jurisdiction over their capital controls.[25] By the early 1990s the Fund had begun

[24] Maurice Obstfeld and Alan M. Taylor, Global Capital Markets: Integration, Crisis, and Growth (Cambridge: Cambridge University Press, 2004), p. 230 and chapter 7 more generally.

[25] Article VI, Section 3 of the Fund's Articles reads: "Members may exercise such controls as are necessary to regulate international capital movements." On the IMF's limited jurisdiction over members' regulation of international capital movements see Joseph Gold, International Capital Movements Under the Law of the International Monetary Fund, no. 21, International Monetary Fund Pamphlet Series (Washington, D.C.: International Monetary Fund, 1977), p. 1ff; and Jacques J. Polak, "The Articles of Agreement of the IMF and the Liberalization of Capital Movements," in Should the IMF Pursue Capital-Account Convertibility?, Princeton Essays in International Finance, no. 207, 1998. On the IMF's jurisdiction over the current account and its influence on members' liberalization of trade flows see Beth A. Simmons, "International Law and State Behavior: Commitment and Compliance in International Monetary Affairs," American Political Science Review, vol. 94, no. 4 (2000), pp. 819-835; and Simmons, "The Legalization of International Monetary Affairs," International Organization, vol. 54, no. 3 (2000), pp. 573-602.

informally to promote capital liberalization, though it did not have the policy tools to oblige member governments to liberalize.[26]

In the middle of the 1990s IMF management proposed and actively promoted an amendment to the IMF's Articles conceived to transform the IMF's formal role in global capital markets. Ultimately the proposal would fail. Two fundamental and distinct changes were envisioned. First, the IMF was to be endowed with a new purpose: to promote the liberalization of capital flows. Listing capital account liberalization among its official purposes would have enabled the Fund, for the first time in its history, to include capital liberalization in the conditions attached to its loans. Second, the IMF was to assume jurisdiction over the international financial regulations of its members, which were, as a general rule, to be prohibited from imposing restrictions on capital movements without Fund approval.

IMF management, following the lead of Managing Director Michel Camdessus, another French policy maker, conceived and promoted the proposal. European executive directors (EDs) of the Fund were the amendment's most enthusiastic proponents. Camdessus and other policy makers within the Fund were most responsible for the organization's embrace of capital liberalization as a practice and the amendment as a legal rule. With no incentive to take responsibility for the failed

[26] Independent Evaluation Office of the International Monetary Fund, The IMF's Approach to Capital Account Liberalization (Washington, D.C.: International Monetary Fund, 2005).

initiative, Camdessus, along with others involved, continues to insist that the idea to amend the Articles "came from within the Fund."[27]

This finding contrasts sharply with the view widely held among scholars and policy makers that the U.S. Treasury and Wall Street financial firms, the "Wall Street-Treasury Complex," proposed and embraced the capital account amendment.[28] There is, remarkably, almost no evidence to support this conventional wisdom. Instead, I show that Treasury policy makers were at best indifferent to the capital liberalization amendment, and some senior officials even opposed its progress. Wall Street was unambiguously against the amendment. The only decisive American influence on the process came when the U.S. Congress eventually, and single-handedly, defeated the proposal altogether.

The proposal to amend the IMF's Articles generated enormous controversy both within and without the organization, in part because the stakes were so high. Still, many supporters of the amendment believed this fundamental revision of the rules of the system to be imminent during the summer of 1997. The financial crisis that swept across Asia and beyond that very summer dealt the proposal, albeit indirectly, a fatal

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[27] Author's interview with Michel Camdessus, Paris, April 19, 2004.

[28] See Jagdish Bhagwati, "The Capital Myth," Foreign Affairs, vol. 77, no. 3 (1998), pp. 7-12 at p. 12; Bhagwati, The Wind of the Hundred Days: How Washington Mismanaged Globalization (Cambridge, Mass.: MIT Press, 2000), chapters 1-3; Bhagwati, In Defense of Globalization (Oxford: Oxford University Press, 2004), chapter 13; and Robert Wade and Frank Veneroso, "The Gathering World Slump and the Battle Over Capital Controls," New Left Review, no. 231 (1998), pp. 13-42, at pp. 35-39.

blow. Although IMF management never officially abandoned the proposal, by the spring of 1999 it was clear that the Articles would not be amended. IMF members, at least those not also members of the EU or OECD, remained free to regulate international capital movements as they wished.

Resolving the Paradoxes of Globalization

Why did Leftist French policy makers, and not the U.S. Treasury and Wall Street financial firms, seek to codify the norm of capital mobility in the world's most influential international organizations? "There is a paradox," observes Pascal Lamy, "of the French role in globalization. There is an obvious difference between the traditional French view on the freedom of capital movements and the fact that French policy makers played crucial roles in promoting the liberalization of capital in the EC, OECD, and IMF."[29] Although it has not yet been satisfactorily answered by scholars, this question is less paradoxical than it at first appears.

Managed Globalization

These French policy makers, as well as many other Europeans, have since the late 1980s sought to foster "managed globalization" – a mondialisation maîtrisée.[30] Writing the rules of global finance has necessarily entailed strengthening the organizations of which the rules are a part. According to the doctrine of managed globalization, the

[29] Author's interview with Pascal Lamy, Brussels, November 12, 2004.

[30] See Philip H. Gordon and Sophie Meunier, The French Challenge: Adapting to Globalization (Washington, D.C.: Brookings, 2001), p. 98ff.

organizations – the EU, the OECD, the IMF – that oversee the rules ought to consist of bureaucracies that are autonomous from the demands of member governments.[31]

Although these international organizations had been at the center of the world economy when it was reconstructed during the 1940s and 1950s, the process of ad hoc globalization had enhanced the influence of multinational firms and banks, as well as the U.S. Treasury. The international financial regime came to be governed less by multilateral legal rules and more by the informal practices and coordination among private financial firms and central banks. The increasing relevance of the Bank for International Settlements (BIS), which represented a more incremental, central-bank centered evolution of the regime, mirrored the diminishing influence of the IMF as the manager of intergovernmental rules.[32]

The European policy makers who held leadership positions in Europe, the OECD, and the IMF – Delors, Chavranski, and Camdessus among them – sought to make their organizations more relevant to the process of globalization by codifying their

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[31] Rawi Abdelal, "Writing the Rules of Global Finance: France, Europe, and Capital Liberalization," Review of International Political Economy (forthcoming).

[32] See Miles Kahler, "Bretton Woods and Its Competitors: The Political Economy of Institutional Choice," in Governing the World's Money, ed. David M. Andrews, C. Randall Henning, and Louis W. Pauly (Ithaca, N.Y.: Cornell University Press, 2002); Kahler, "Defining Accountability Up: The Global Economic Multilaterals," Government and Opposition, vol. 39, no. 2 (2004), pp. 132-158; Ethan B. Kapstein, Governing the Global Economy: International Finance and the State (Cambridge, Mass.: Harvard University Press, 1994); Kapstein, "Resolving the Regulator's Dilemma: International Coordination of Banking Regulations," International Organization, vol. 43, no. 2 (1989), pp. 323-347; and Beth A. Simmons, "Why Innovate? Founding the Bank for International Settlements," World Politics, vol. 45, no. 3 (1993), pp. 361-405.

jurisdiction over their members' capital controls. Through these international organizations and their rules, French and European policy makers might thereby gain more influence over global finance. Observes Lamy, "One resolution of this paradox is the French approach to the problem of liberalization: If you liberalize, you must organize."[33] The liberal rules of the international financial regime were constructed not to limit the interventions of individual governments but to build the capacity of international organizations. Those organizations could then supersede the authority of the capital markets' most powerful states, Germany and the United States.

The indifference of the U.S. Treasury and opposition of Wall Street to the codification of a liberal regime for global finance are, when seen from this perspective, more easily understood. Both the Treasury and Wall Street generally favored liberalization and the internationalization of finance. But U.S. policy makers and bankers recognized, as did many Europeans, that the codification of a liberal regime would increase the influence of international organizations and their bureaucracies. The proposed amendment to the IMF's Articles elicited representative responses. Former Treasury Secretary Lawrence Summers called the proposal "a bureaucratic imperative" for the Fund.[34] Reflecting the sentiment of much of Wall Street, The Banker described the amendment as a "Machiavellian device by Camdessus and his lieutenants to wrest back from the market place some of the power it has lost as the principal force in world

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[33] Author's interview with Lamy.
[34] Author's interview with Lawrence Summers, Cambridge, Mass., April 30, 2004.

financial markets."[35] Although the Fund is often construed to have bailed out private financial interests in crises, those same bankers do not, in general, trust the Fund.

Indeed, in retrospect it is surprising that so many observers thought that the U.S. Treasury or Wall Street would push to codify the norm of capital mobility in a way that would empower international organizations.[36] These are straightforward power politics, as rational and self-interested as can be.[37] The U.S. Treasury already effectively governs global finance; it requires little assistance from the European Commission, the CMIT, or IMF management, and with respect to the latter two, has little incentive to delegate to them. The U.S. government was comfortable delegating only to private firms: Moody's and S&P. American banks and financial firms are interested not in worldwide capital mobility, but in access to a handful of emerging markets, access they can, in general,

[35] "IMF/World Bank: Can Banking Systems Cope? The Historic Hong Kong Meetings Will Discuss Controversial New Powers for the IMF in Response to Recent Financial Crises," The Banker, September 1, 1997.

[36] On the lack of American support for multilateral, codified rules in a similar context, see Louis W. Pauly, Opening Financial Markets: Banking Politics on the Pacific Rim (Ithaca, N.Y.: Cornell University Press, 1988), p. 172 ff. David Spiro describes a similar contest between the U.S. Treasury and the IMF for control over the process of petrodollar recycling during the 1970s; see The Hidden Hand of American Hegemony: Petrodollar Recycling and International Markets (Ithaca, N.Y.: Cornell University Press, 1999).

[37] Thus it is easy to explain U.S. behavior with theories derived within the Realist tradition of international political economy. See Jonathan Kirshner, "The Political Economy of Realism," in Unipolar Politics: Realism and State Strategies After the Cold War, ed. Ethan Kapstein and Michael Mastanduno (New York: Columbia University Press, 1999). For classic works of Realist political economy, see Robert Gilpin, U.S. Power and the Multinational Corporation (New York: Basic Books, 1975); and Stephen D. Krasner, Defending the National Interest (Princeton, N.J.: Princeton University Press, 1978).

acquire without the liberalizing efforts of policy makers such as Delors, Chavranski, or Camdessus. A recent series of bilateral treaties with countries such as Singapore and Chile is representative of the ability of the American financial community to achieve its goals of access to major emerging markets without the efforts of international organizations.[38]

The Idiosyncrasies of Organization-Building

The content of the intergovernmental bargains that promised to strengthen the European Commission, CMIT, and IMF as organizations and bureaucracies also reflected idiosyncratic politics. The single European capital market envisioned by policy makers in Paris and by the Delors Commission in Brussels was not necessarily open to the rest of the world. Even U.K. negotiators, who favored European financial integration, preferred to retain the option of Europe-wide capital controls vis-à-vis third countries as a means to increase Europe's leverage in global financial markets.

The German insistence on the erga omnes principle was firm, however. Without financial integration the French could not make progress toward monetary union, one of the ultimate goals. The French government and the Delors Commission acceded to German demands and based Europe's capital liberalization on the principle of freedom of movement to and from all countries. With regard to capital, at least, European

[38] See, for example, Edward Alden, "U.S. Backs Curbs on Capital Controls: Free Trade Administration Wants Future Agreements to Be Based on Chile and Singapore Deals," Financial Times, April 2, 2003.

integration was equivalent to globalization, and subsequent enlargements of the Union have expanded the scope of nearly absolute freedom of movement for capital.

Liberalism and the Left

For many European policy makers on the Left, their governments' embrace of capital liberalization represented more than expedience or institutional necessity. Important decision makers within the French Left in particular had by the middle of the 1980s come to interpret capital controls primarily as a policy tool that subordinated the middle classes, rather than the traditional means to restrain and tax capital to redistribute wealth and stimulate economic growth.

The French experience with controls to curb capital flight following the election to president of Socialist François Mitterrand profoundly influenced Delors, Chavranski, and Camdessus (all three in the Mitterrand government at the time), as well as many others on the Left. The capital controls seemed to produce perverse distributional consequences: the rich and well-connected removed their money from France, and the middle class remained constrained by controls. "The Left's embrace of liberalization was similar to its fight against inflation," argues Lamy. "Eventually we recognized that it was the middle classes that bore the burden of regulation most, as they did with inflation."[39] Unable to control the rich, the French Left was "obliged to liberate the

[39] Author's interview with Lamy.

rest."[40] Many scholars would take issue with Lamy's characterization of the effects of both inflation and capital controls, but this is how policy makers of the French Left interpreted their recent past, and their interpretations guided later decisions.

Although it is often casually asserted that capital controls "do not work," few scholars have explored precisely how they did not work and why their ineffectiveness might matter politically.[41] The diminishing effectiveness of capital controls became politically salient, but not because bankers and managers demanded liberation from unwieldy regulations. Their liberation was already substantial, if still incomplete and full of nuisance. Rather, some policy makers on the Left in Europe liberalized on behalf of their middle classes. Such were the lessons learned by the Left during the era of ad hoc globalization.

Constitutive Norms and Market Expectations

The sociological analysis I present in this book also complements the conclusion, reached by economists and political scientists, that capital regulations and liberalizations are signals interpreted by financial markets. Market participants, in this way of

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[40] Author's interview with Henri Chavranski, Paris, April 2, 2004.

[41] Scholars have generally not paid sufficient attention to the distributional politics of capital controls. A notable exception is Laura Alfaro, "Capital Controls: A Political Economy Approach," Review of International Economics, vol. 12, no. 4 (2004), pp. 571-590. The distributional politics of capital liberalization, in contrast, are well studied by political scientists and economists. See Jeffry A. Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," International Organization, vol. 45, no. 4 (1991), pp. 425-451; and Jonathan Kirshner, "Disinflation, Structural Change, and Distribution," Review of Radical Political Economics, vol. 30, no. 1 (1998), pp. 53-89.

thinking, infer meanings from policies. Capital liberalizations are interpreted as positive signals, while capital controls are negative signals.[42] If these market expectations and inferences could be treated exclusively as fixed parameters, we might not need to delve further into the social environment of the financial markets.[43]

These expectations and inferences are not parametric, however. In, say, 1958 capital controls signaled neither heresy nor even unfriendliness to financial markets. By 1998, however, capital controls apparently signaled poor international financial citizenship. The capital account regulations themselves were objectively identical during the 1950s and 1990s, and yet international organizations, ministries of finance,

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[42] The classic source of this argument is Leonardo Bertolini and Allan Drazen, "Capital Account Liberalization as a Signal," American Economic Review, vol. 87, no. 1 (1997), pp. 138-154. Other scholars have since emphasized the information content of a variety of policy stances. On capital controls as a negative signal, see Geoffrey Garrett, "The Causes of Globalization," Comparative Political Studies, vol. 33, nos. 6/7 (2000), pp. 941-991, at p. 975; and Barry Eichengreen, "Capital Account Liberalization: What Do the Cross-Country Studies Tell Us?" World Bank Economic Review, vol. 15, no. 3 (2002), pp. 341-365, at p. 359. On the reputational payoffs of policy choices in the context of ideological consensus, see Beth A. Simmons and Zachary Elkins, "The Globalization of Liberalization: Policy Diffusion in the International Political Economy," American Political Science Review, vol. 98, no. 1 (2004), pp. 171-189, at pp. 172-173.

[43] As a matter of intellectual principle, however, social meanings, the inferences that audiences draw, can only be a result of social norms. See Max Weber, Economy and Society, ed. Guenther Roth and Claus Wittich (Berkeley: University of California Press, 1978), pp. 4-5. A recent evaluation of social norms and signals can be found in Cass R. Sunstein, "Social Norms and Social Roles," Columbia Law Review, vol. 96, no. 4 (1996), pp. 903-968, at p. 925.

credit rating agencies, financial journalists, bankers, and managers drew different inferences from their implementation.[44]

International organizations affected the international financial system through mechanisms that are at once regulative (rationalist) and constitutive (constructivist or sociological). Once the norm of capital mobility was codified in Europe and the OECD, the European Commission and the CMIT monitored the compliance of members, thereby helping to regulate and constrain their behavior.[45] International organizations also influenced the social context of the international financial system by fixing the meanings of capital controls as policy tools, defining for their members the range of legitimate policies, and disseminating the new orthodoxy of freedom of movement for capital.[46]

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[44] On the importance of the "implicit rules" of the international financial architecture, see also Ronald I. McKinnon, "The Rules of the Game: International Money in Historical Perspective," Journal of Economic Literature, vol. 31, no. 1 (1993), pp. 1-44, especially pp. 2-3, 13, and 29.

[45] These effects have generally been analyzed by scholars operating within the rationalist tradition of institutional analysis. See Robert O. Keohane, After Hegemony: Cooperation and Discord in the World Political Economy (Princeton, N.J.: Princeton University Press, 1984); and Lisa L. Martin and Beth A. Simmons, "Theories and Empirical Studies of International Institutions," International Organization, vol. 52, no. 4 (1998), pp. 729-757.

[46] On constitutive norms, see Peter J. Katzenstein, "Introduction: Alternative Perspectives on National Security," in The Culture of National Security: Norms and Identity in World Politics, ed. Katzenstein (New York: Columbia University Press, 1996), p. 5ff; and John Gerard Ruggie, "What Makes the World Hang Together? Neo-Utilitarianism and the Constructivist Challenge," in his Constructing the World Polity, p. 22ff. On the regulative and constitutive power of international organizations, see Alastair Iain Johnston, "Treating Institutions as Social Environments," International

The liberal rules of the EU and OECD defined the economic policy "scripts" members were supposed to follow.[47] The EU delineated the boundaries of legitimate policies enacted by "European" states; the rules of the OECD constituted the policy practices of "developed" states. These scripts articulated the obligation of European and developed states to permit capital to move freely. Because these rules define the policy practices that lead members to recognize what constitutes appropriate behavior on the part of other governments, the EU and OECD also informed the expectations of the financial markets. The EU and OECD codified the norm of capital mobility and thereby hardened it into a new orthodoxy.

The EU and OECD then became teachers of their norms and rules, and during the 1990s the organizations found eager pupils among the countries seeking to join their organizations. The real and symbolic benefits of membership encouraged aspiring members to embrace the respective rules, including capital liberalization, often without questioning the content of the constitutive rules that would ensure their recognition as "European" and "developed." A Czech central bank official recalls that central and east European governments competed during the early 1990s to be "the best pupil of the

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Studies Quarterly, vol. 45, no. 4 (2001), pp. 487-515; and Michael Barnett and Martha Finnemore, Rules for the World: International Organizations in Global Politics (Ithaca, N.Y.: Cornell University Press, 2004), p. 7.

[47] On the sociological insight that "individuals behave according to scripts that are tied to social roles," see Frank Dobbin, "The Sociological View of the Economy," in The New Economic Sociology, ed. Dobbin (Princeton, N.J.: Princeton University Press, 2004), p. 4.

developed market economies."[48] This competition was also apparent from Brussels, where one Commission negotiator remarked on prospective members' "eagerness to be perceived as right up to European standards for openness to capital movements."[49] The countries that joined the OECD and EU readily embraced the script of capital liberalization. Although the Commission and CMIT were enthusiastic proponents of the script, neither could force acceptance of their rules; they merely enforced and interpreted the rules to which members had already agreed.[50]

Outline of the Book

In chapter 2 I develop further the book's arguments about the causes and consequences of liberal rules for the international financial regime. An important conclusion emerging from my evaluation of the alternate arguments and the conventional wisdom is that an analytical framework informed by social constructivism

[48] Author's interview with Oldřich Dědek, Prague, March 24, 2004.

[49] Author's interview with Stephane Ouaki, Brussels, November 3, 2004.

[50] This diffusion occurred through a combination of normative and mimetic isomorphism. On normative isomorphism, see G. John Ikenberry and Charles A. Kupchan, "Socialization and Hegemonic Power," International Organization, vol. 44, no. 3 (1989), pp. 283-315; Jeffrey T. Checkel, "Why Comply? Social Learning and European Identity Change," International Organization, vol. 55, no. 3 (2001), pp. 553-588. On mimetic isomorphism, see Stephen D. Krasner, Sovereignty: Organized Hypocrisy (Princeton, N.J.: Princeton University Press, 1999), p. 64ff. On the diffusion of economic policy practices, see Beth Simmons, Frank Dobbin, and Geoffrey Garrett, "The International Diffusion of Liberalism," unpublished ms., June 2004; Simone Polillo and Mauro F. Guillén, "Globalization Pressures and the State: The Worldwide Spread of Central Bank Independence," American Journal of Sociology (forthcoming); Witold J. Henisz, Bennet A. Zelner, and Mauro F. Guillén, "International Coercion, Emulation, and Policy Diffusion: Market-Oriented Infrastructure Reforms, 1977-1999," unpublished ms., January 2005.

proves essential to a coherent narrative of the emergence of the current era of global finance. In this chapter I also challenge a variety of alternate arguments for the emergence of liberal rules in the international financial system, including those that emphasize: the U.S. Treasury and Wall Street; the rise of "neo-liberalism" and the Right in the United States and Europe; the accumulation of scientific knowledge of the benefits of capital liberalization; the end of system-wide fixed exchange rates; and technological and other changes that altered the balance of power between governments and financial markets.

Many of these complementary arguments emphasize how the balance of power shifted away from governments and toward financial markets. Financial markets seem to have been enabled by successive trends in the international economy. But trends that enable capital mobility are not the same as, nor do they inexorably lead to, rules that oblige governments further to liberalize capital. Although we now know a great deal about the process and politics of financial internationalization, critical parts of the story remain to be told.

In chapter 3 I describe the place of capital controls in the compromise of embedded liberalism during the 1940s and 1950s. Drawing on archival and secondary sources, I show how the policy makers who negotiated the IMF's Articles of Agreement, Europe's Treaty of Rome, and the OECD's Code of Liberalization of Capital Movements sought to distinguish between "productive" long-term capital and "speculative" short-term capital movements. For each organization the problem of controlling "hot money" was paramount. The necessity of regulating short-term capital movements was doctrinal and practical.

Next I trace the evolution of the informal practices and formal rules of Europe (chapter 4), the OECD (chapter 5), and the IMF (chapter 6). Each organization faced a critical moment during which the bureaucracies of the organizations and representatives of some member countries sought to transform fundamentally the non-liberal rules regarding capital controls. These three chapters are based on evidence drawn from recently released archival documents, as well as from interviews conducted between 2002 and 2005 with policy makers situated in the three organizations and eight member countries, as well as representatives of private financial firms (see Appendix).

A book about the evolution of worldviews necessarily engages with the producers and consumers of those ideas, and I have sought to do so directly. Whenever possible I have corroborated the accounts of interviewees with primary documents, contemporary media reports, and the accounts of other interviewees. Only in a few cases have I been forced to rely completely on the admittedly imperfect (and potentially self-serving) recall of one or two individuals for the narratives presented in these chapters. Although I recognize the drawbacks of relying on the testimony of the principals involved in these politics, no superior means of discussing these important moments in recent economic and political history has yet become available. In any event, these additions to the existing evidence will contribute to our understanding of developments as witnessed and influenced by these individuals.

After the case studies of the three organizations in chapters 4-6, I attempt in chapter 7 to describe the evolution of the informal norms of the international financial system by tracing the doctrines and practices of Moody's and S&P. For this chapter I rely on the content of the rating agencies' official primers on sovereign rating and a number of sovereign rating reports published between the early 1980s and the end of the 1990s, as well as on a handful of interviews conducted with Moody's and S&P managers and analysts.

In chapter 8, I argue that the financial crisis of 1997-1999 exerted, indirectly and directly, an enormous influence on the three international organizations and the credit rating agencies. Much as the financial crisis of 1931 became a touchstone for debates about the regulation of international capital flows, so, too, has the financial crisis that erupted in Thailand in the middle of 1997, spread to Russia during the summer of 1998, and culminated in Brazil in January 1999.

The organizations and firms that comprise the international financial community appear to have reconsidered the benefits, risks, and institutional preconditions of capital liberalization.[51] The credit rating agencies, for their part, have emerged as purveyors of caution in the developing world, emphasizing the risks of liberalization and praising the

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[51] See, for example, Barry Eichengreen, "The International Monetary Fund in the Wake of the Asian Crisis," and Benjamin J. Cohen, "Taming the Phoenix? Monetary Governance after the Crisis," both in The Asian Financial Crisis and the Architecture of Global Finance, ed. Gregory W. Noble and John Ravenhill (Cambridge: Cambridge University Press, 2000).

use of controls by countries with weak domestic financial systems, such as China and India. The OECD's CMIT softened its demands that prospective members liberalize capital flows quickly and comprehensively. The proposed amendment to the IMF's Articles was dealt a fatal blow by the crisis, and IMF staff became reluctant to encourage members to liberalize. When the Slovak Republic joined the OECD in 2000, for example, Elena Kohútiková of the central bank was surprised at how profoundly the message from the international financial community had changed:

> After the crises of 1997 and 1998 the OECD, IMF, and U.S. Treasury encouraged us to slow down our liberalization of short-term capital flows. There was a change in the knowledge base. The dangers of short-term capital flows were recognized more clearly. The shift in sentiment was remarkable: at first it was, 'You do have to do everything immediately.' Then it became, 'You have to do everything step by step, and please be careful about short-term capital movements.'[52]

The autumn of 1998 was, in a sense, the high point of the norm and the attempt to codify the rule of capital mobility for all countries. The orthodoxy of capital's freedom was undermined everywhere except in the EU, primarily because the codified norm of capital liberalization for European states is literally not open to interpretation or discussion. The EU, unlike the OECD and IMF, is not the home of experts and their

[52] Author's interview with Elena Kohútiková, Bratislava, October 27, 2004.

fluid wisdom; the EU is the home of rules. The entire process of European integration through evolving rules enforced by the Commission is built around the idea that it is effective to bureaucratize difficult issues. Few issues in the history of European integration were as difficult as the liberalization of capital movements, but it is now settled definitively. Voices of caution emanate from New York, Washington, and Paris. Only in Brussels does the codification of the norm of capital mobility remain complete and secure from the skepticism that followed the financial crisis of 1997-99. The emergence of a liberal regime for global finance is not best understood as a conspiracy, and much less as one orchestrated by American policy makers and bankers. The most influential plotters were French socialists, German central bankers, and European bureaucrats.

I conclude with a reflection on the process of interpreting financial crises and their influence on policy orthodoxy and the practices of firms, governments, and international organizations. The lessons of financial crises are not self-evident; they are subject to interpretation and debate.[53] These interpretations evolve with the passage of time. Just as Milton Friedman argued during the early 1950s that the policy makers and economists of the 1940s had over-reacted to the crises of the 1930s, soon there may be those who argue that the Asian financial crisis did not warrant a renewed skepticism of

[53] Blyth, Great Transformations; Wesley W. Widmaier, "Constructing Monetary Crises," Review of International Studies, vol. 29, no. 1 (2003), pp. 61-77.

international capital flows.[54] In the first years since the most recent crisis, however, with the havoc wrought still fresh in the minds of policy makers, a consensus of caution prevails. Each generation forgets the lessons of the last and renews its awareness of the risks on the occasion of an international financial crisis.[55] What appear to be permanent orthodoxies about capital movements are not permanent at all.

[54] Milton Friedman, "The Case for Flexible Exchange Rates," in his Essays in Positive Economics (Chicago: Chicago University Press, 1953), pp. 176-177.

[55] John Kenneth Galbraith suggests a 20-year cycle "from illusion to disillusion and back to illusion." See A Short History of Financial Euphoria (New York: Penguin [1990] 1994), pp. 12-13 and 88-89.