

**Capital Rules:
Institutions and the International Monetary System**

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This chapter, “The Rules of Globalization,” is the introduction to a book manuscript about the institutional foundations of global capital markets. The question I seek to answer is: Why were capital controls orthodox in 1944, but heretical in 1997? The scholarly literature, as well as the conventional wisdom, focuses on the role of the United States in promoting capital liberalization. I show, in contrast, that the United States encouraged capital liberalization bilaterally, but never embraced multilateral rules that codified the norm of capital mobility. Rather, it was the French, paradoxically, who wrote the rules in favor of capital freedom, despite having obstructed the creation of such rules for three decades. For the rules that matter most – in the OECD, EU, and IMF – the United States was, respectively, inconsequential, irrelevant, and indifferent. Europe did not capitulate to global capital; the French, and Europe as a whole, created globalization as we know it. Once liberal rules were codified in the OECD and EU, these organizations defined the legitimate policy practices of “developed” and “European” states. Credit rating agencies adopted this new orthodoxy during the 1990s and reinforced the trend toward capital liberalization. In 1997 and 1998, however, the Asian financial crisis fundamentally undermined this policy consensus. Since that time the IMF and U.S. Treasury have emerged as voices of caution, while the European Commission is today the last bastion of unmitigated liberalism in international finance. In this book I account for the rise and fall of the new orthodoxy and for the creation of the formal rules that valorized and privileged the free flow of capital.

Chapter One

The Rules of Globalization

The war between heaven and hell ignored the money issue, leaving capitalists and socialists miraculously united. Where Ricardo and Marx were as one, the nineteenth century knew not doubt.

— Karl Polanyi

Capital was global at the end of the nineteenth century, and no one doubted that it should be so. The politics of the Right (the orthodox David Ricardo) and the Left (the communist Karl Marx) had converged, but on this issue only: to restrict the freedom of capital was against the unwritten rules of the international economy. These unwritten rules defined the classical gold standard. Capital controls¹ were neither normal nor legitimate. During the tumultuous years between the two world wars, the narrow consensus of Ricardo and Marx on capital's freedom collapsed. Capital's freedom collapsed with it. The first era of global capital had come to an end.

But by 1945 Right and Left arrived at a new consensus: capital was to be national, and not, emphatically not, global. The post-war consensus on regulating capital was opposite the nineteenth century's privileging of capital mobility. Members of the international financial community collectively shared a set of beliefs about the destabilizing consequences of "hot money" and the need for government autonomy from international capital markets. The 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 market efficiency with the values of

¹ 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 is most often based on 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. The "capital account" is now the "capital and financial account," and most of the transactions previously measured in the capital account are now in the financial account. 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.

social community and domestic welfare as the “embedded liberalism 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.² 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 International Monetary Fund (IMF or Fund), the European Community (EC), and the Organization for Economic Cooperation and Development (OECD). 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.³ As John Maynard Keynes, one of the authors of the IMF's

² 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.

³ 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

Articles, explained with typical elegance to the House of 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.”⁴

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 early 1980s, four financially consequential states, the United States, the United Kingdom, Germany, and Japan, had liberalized capital flows across their borders. American, British, German, and Japanese banks began to operate in financial markets that were no longer national, but also not yet global. The unwritten rules of the international monetary system began 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 compromise of embedded liberalism was unraveling.⁵ Capital controls, once Bretton Woods orthodoxy, were, according to a growing number of policy makers, becoming heretical again.⁶

Some policy makers in these four increasingly liberal-minded countries sought to revise the formal rules of the system, to codify the emerging norm of capital mobility. These efforts began in the EC and OECD, but the organizations’ members could not reach agreement on the desirability of formally obliging one another to liberalize capital flows. The internationalization of finance proceeded, but unevenly: most governments continued to restrict capital flows, and those that had liberalized were free to reverse course. Many policy makers, bankers, and managers worried that the globalization of finance could not be completed and made secure in the absence of codified rules that

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.

⁴ 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.

⁵ 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).

⁶ 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).

avored free capital flows and obliged governments to maintain their financial liberalism.

Financial internationalization had proceeded, but its evolution had been *ad hoc*. From the perspective of most American policy makers and the private financial community in the United States, *ad hoc* globalization was preferred to a more organized, structured system. The rise to preeminence of two credit rating firms, Standard & Poor's (S&P) and Moody's Investors Service, epitomized the American approach to globalization. S&P and Moody's were, first and foremost, American firms. Their influence on international debt markets had been enabled by their dominance in the domestic U.S. market and a quasi-regulatory status resulting from incorporation of their ratings into a wide range into financial regulations. The premise of the firms' authority was their enhancement and centralization of the interests of the market. S&P and Moody's did not constrain the behavior of the U.S. government; their influence was felt much more in the developing world. Indeed, S&P and Moody's came to be understood around the world as responsible for propagating and diffusing credit practices well suited to U.S. economic institutions and familiar to U.S. investors. The centrality of these firms to financial globalization had apparently evolved without any American plan to place them there. S&P and Moody's had become – informally – part of the international financial architecture.

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. EC members were obliged by a 1988 Council directive to remove all restrictions on the movement of capital among member states, as well as between members and non-members. 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. For some 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 catch up to their peers.

The most profound effect of these rules was felt in the 1990s and the first few years of the new century during negotiations with prospective members. The privileges of membership being contingent on meeting the liberal standards of these new 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. “The new financial globalization,” observe economists Maurice Obstfeld and Alan Taylor, “is for the most part confined to rich countries.”⁷

The last non-liberal rule was potentially the most consequential. 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 trade restrictions imposed by its members, it has no jurisdiction over their capital controls.⁸ In the middle of the 1990s IMF management proposed and actively promoted an amendment conceived to transform the IMF’s formal role in capital liberalization. Two fundamental and distinct changes were assumed. First, the IMF was to be endowed with a new purpose: to promote the liberalization of capital flows. Listing capital account liberalization among its 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.

The proposal to amend the IMF’s Articles generated enormous controversy both within and outside the organization. Still, many supporters of the amendment believed this fundamental revision to 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 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.

⁷ 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.

⁸ 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.

How the French Wrote the Rules of Globalization

Although it was a conjuncture of events that led to the formulation of new rules for the international monetary system, three policy makers played decisive roles. Jacques Delors of the EC, Henri Chavranski of the OECD, and Michel Camdessus of the IMF took part in proposing and writing new liberal rules for the members of their organizations. By all accounts, a consensus in favor of the codification of the norm of capital mobility would have been inconceivable without them. Delors, Chavranski, and Camdessus share a great deal in common, but one attribute stands out: each of them is French.⁹

This fact is quite remarkable, for France had for three decades done more than any other country to obstruct the creation of new rules in favor of capital mobility. “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.”¹⁰ The French first had to reverse radically their views on the regulation of capital flowing in and out of their own country. France had arrived rather late to the celebration of capital’s freedom.

When in the spring of 1981 François Mitterrand was elected president of France and the Socialist Party won a majority in the National Assembly, the European Left was full of hope, the European Right consumed by fear. The broader significance of this episode, however, was that choice still seemed possible in a world of heightening economic interdependence that seemed to privilege the needs of capital. Before globalization appeared to be inescapable and inexorable French socialists sought to reestablish the policies of Keynesian reflation and redistribution. The ambitions of Mitterrand and the Socialists knew few bounds, and their efforts to remake the French economy were massive.

Soon after the Mitterrand experiment began, however, it started to unravel, in part because the financial markets did not trust the new French government. So capital fled France. The French government tightened controls on capital outflows first in May 1981, then again in March 1982, and by March 1983 the regulations had been rewritten as restrictively as possible. Importers and exporters were not allowed forward exchange

⁹ See Rawi Abdelal, “The Reunion of Ricardo and Marx: How the French Wrote the Rules of Globalization,” unpublished ms., Harvard Business School, December 2004.

¹⁰ Author’s interview with Pascal Lamy, Adviser to French Economics and Finance Minister Jacques Delors [1981-1983], Deputy Chief of Staff to French Prime Minister Pierre Mauroy [1983-1984], Chief of Staff and Representative of European Commission President Jacques Delors [1985-1994], Member of French Socialist Party’s Steering Committee [1985-1994], European Commissioner for Trade [1999-2004], Brussels, November 12, 2004.

transactions, foreign travel allowances were further reduced, personal credit cards could not be used abroad, and the infamous *carnet de change*, a booklet in which the French were to record their foreign exchange transactions, was introduced. The French had, according to John Goodman and Louis Pauly, introduced “draconian capital controls.”¹¹

Still the French government was unable to halt the flight of capital. Anecdotal evidence suggests that the well-to-do and the well-connected, wealthy individuals and powerful firms, continued to evade even the most cleverly designed and stringently enforced controls. By 1983 it was clear that French capital controls constrained the middle class most of all, while the rich circumvented them with impunity. Henri Chavranski reflects: “Our capital controls failed not in the sense that everyone was able to elude their grasp; they failed in the sense that those who were less well connected bore their burden most.”¹²

Speculators, meanwhile, repeatedly attacked the franc, which had been devalued three times in 18 months. Mitterrand and the Socialists reversed course in the spring of 1983. The *tournant*, the Mitterrand U-turn, was an admission of defeat. Capital had won the battle of wills and ideologies. The socialist experiment had failed. Mitterrand had succeeded only in destroying Keynesian reflation and redistribution as a legitimate alternative once and for all.

Between 1983 and 1986 the French embraced both the integration of their own country into international financial markets and their own version of *rigueur*, a financial and monetary austerity without precedent in modern French history. Then, after 1986 French policy makers played a leading role in making globalization, as we know it, possible.

All the more paradoxical is that Delors had been, and still is, one of the most influential members of the French Socialist Party. Delors was the architect of French *rigueur* and the catalyst of the party’s rethinking of its approach to finance. Although neither had been involved in French party politics, Chavranski and Camdessus had both made their marks as civil servants in the Treasury of the administration of Socialist president Mitterrand, by whom Camdessus was appointed Governor of the Banque de France. This was a moment, in other words, when the views of the French Left and Right on capital liberalization were indistinguishable. The broader social phenomenon in France became known as *la pensée unique*, an economic orthodoxy embraced across the political spectrum.

¹¹ John B. Goodman and Louis W. Pauly, “The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets,” *World Politics*, vol. 46, no. 1 (1993), pp. 50-82, at p. 73.

¹² Author’s interview with Henri Chavranski, Chair of the Committee on Capital Movements and Invisible Transactions (CMIT) of the OECD [1982-1994], Paris, April 2, 2004.

My resolution of this French paradox is premised on three themes that run through the stories of the EC, OECD, and IMF. One, France has displayed a consistent approach to the liberal imperatives of globalization: “managing” globalization with formal rules, even if such rules are essentially liberal. The French foreign policy establishment has conceived the notion of *mondialisation maîtrisée*, or “managed globalization.”¹³ The French vision of ruling globalization contrasts starkly with *ad hoc* globalization of the sort that the United States, as well as the United Kingdom, has nurtured. Observes Lamy, “One resolution of this paradox is the French approach to the problem of liberalization: If you liberalize, you must organize.”¹⁴

Two, of these episodes the most decisive was the liberalization of capital movements in Europe. The rewriting of the EC’s rules to favor capital freedom was based as well on an idiosyncratic logic: the French accepted capital liberalization because it was part of the European project. Europe’s drive toward capital freedom, in the eyes of some observers, constituted a French *quid pro quo* with the Germans, who had long sought such a rule: capital freedom for the promise of monetary union. The result was profoundly important, for the European Union ended up with the most liberal rules imaginable: members were obliged to liberate all capital flows, no matter the source or direction.

Three, the influence of Delors, Chavranski, and Camdessus was, more broadly, the achievement of a vocal minority within the French policy establishment that sees ostensibly liberal policies as instruments for social purposes. Delors reflects:

Historically there has always been a minority position in France that views inflation as the most damaging for the long-term health of the economy: undermining the value of the currency, tempting capital to flee, and hurting the poor and middle classes. This minority position can be traced back even to de Gaulle and Rueff, and more recently a minority in the Left and in the Christian Democrats. This minority has always sought to modernize France: to stabilize the currency, to fight inflation, and to promote healthy growth and employment. And it happened that this minority won in France during the 1980s. It was a long and difficult struggle.¹⁵

For this minority, including some on the Left in France, the Mitterrand-era capital controls produced perverse distributional consequences: the rich and well-connected spirited their money out of France, and the middle class remained

¹³ Philip H. Gordon and Sophie Meunier, *The French Challenge: Adapting to Globalization* (Washington, D.C.: Brookings, 2001), p. 98.

¹⁴ Author’s interview with Lamy.

¹⁵ Author’s interview with Jacques Delors, French Minister of Economics and Finance [1981-1984], President of the European Commission [1985-1995], Paris, December 2, 2004.

constrained by controls.¹⁶ Although the goals of the Left had not changed, the world had. And the new world of internationalized financial markets meant that capital controls, long one of the Left's tools for macroeconomic management on behalf of the working and middle classes, no longer empowered labor and the intelligentsia. Capital controls that constituted a mere nuisance for the rich had become a veritable prison for everyone else. Lamy argues, "The Left's embrace of liberalization was similar to its fight against inflation. Eventually we recognized that it was the middle classes that bore the burden of regulation most, as they did with inflation."¹⁷ Unable to control the rich the French Left decided to free everyone else. "We recognized, at last," Chavranski recalls, "that in an age of interdependence capital would find a way to free itself, and we were obliged to liberate the rest."¹⁸

The Europe of Jacques Delors

The European economy envisioned by the authors and negotiators of the 1957 Treaty of Rome was not unconditionally liberal. Goods, services, and people were supposed to flow freely. Capital, however, was not, except "to the extent necessary to ensure the proper functioning of the Common Market," and without jeopardizing the internal and external financial stability of members.¹⁹ The conditionality of the obligation to liberalize capital reflected, in part, the widespread consensus among policy makers around the world that capital flows ought to be controlled in order to avoid financial crises. The Treaty's conditionality of capital liberalization also resulted from bargaining among Europe's founding members. Germany had argued for capital's freedom, whereas France, Italy, and the Netherlands had rejected such a codified obligation. This same division persisted into the 1970s.²⁰

¹⁶ 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.

¹⁷ Author's interview with Lamy.

¹⁸ Author's interview with Chavranski.

¹⁹ See the discussion in Age F. P. Bakker, *The Liberalization of Capital Movements in Europe* (Dordrecht: Kluwer, 1996), pp. 42-43. The European Court of Justice confirmed that freedom of capital movements was not implied by the Treaty in the *Casati* decision of 1981. See Peter Oliver and Jean-Pierre Baché, "Free Movement of Capital Between the Member States: Recent Developments," *Common Market Law Review*, no. 26 (1989), pp. 61-81.

²⁰ Bakker, *The Liberalization of Capital Movements in Europe*, pp. 34-35.

The legal implication of the Treaty's wording was that members' obligations to liberalize capital could be redefined only by a new Treaty or by directives formulated by the European Commission and approved unanimously by the Council that would, in essence, define what members agreed to constitute "the extent necessary" for the common market.²¹ Europe would thus wait for members to catch up to their obligations to allow the freedom of goods, services, and people. With regard to capital, in contrast, the firmness of members' obligations would change over time.

The Commission began to define and expand members' obligations to liberalize capital with directives in 1960 and 1962, but little progress was made. The 1960 directive established a complex list of categories of transactions ranging from those most closely linked to the other basic freedoms articulated in the treaty (direct investments and personal capital movements, for example) to those considered least necessary (such as "short-term capital movements"). Members were obliged to liberalize only transactions deemed essential to the functioning of the common market. That turned out to be a short list indeed.

For more than twenty years not a single new directive for liberalizing capital was issued from Brussels. A third directive was submitted to the Council in 1967, but a decade of negotiation led nowhere. "Opposition came from all sides," writes Age Bakker, "but first and foremost from France and the Netherlands."²² The only other movement on capital pushed in the direction of more control, rather than liberalization. A 1972 directive that obliged members to maintain the apparatus of capital controls "to curtail undesirable capital flows" was issued.²³ When the German enthusiasm for liberalization was shared by the Dutch and British in the early 1980s those three countries sought once more to bring capital liberalization to the agenda in Brussels. Again, the "uncompromising, dogmatic attitude of France" blocked the initiative.²⁴

The Mitterrand *tournant* changed everything. Although French policy makers had merely capitulated to the reality of their capital flight – their conversion to liberalism was still in the making – they had also begun to reconsider their approach to the freedom of capital movements in Europe. Then, on January 1, 1985, Delors, the architect of *rigueur*, became president of the European Commission, a post he would hold for a decade.

²¹ Article 69 of the Treaty specified this role for the Commission. See Tommaso Padoa-Schioppa, "Capital Mobility: Why is the Treaty Not Implemented?" in his *The Road to Monetary Union in Europe: The Emperor, the Kings, and the Genies* (New York: Oxford University Press, 1994), p. 27.

²² Bakker, *The Liberalization of Capital Movements in Europe*, p. 96.

²³ Bakker, *The Liberalization of Capital Movements in Europe*, pp. 116-118.

²⁴ Bakker, *The Liberalization of Capital Movements in Europe*, pp. 147-152 and 153.

After visiting the members' capitals and sensing that the time was ripe for an ambitious new integration initiative based on market principles, Delors moved quickly to produce the June 1985 White Paper that was the first outline of a plan to complete the European internal market by January 1, 1993.²⁵ Even in the summer of 1985, however, neither the Commission nor the White Paper outlined a new legal obligation for the complete liberalization of capital movements in Europe. In December 1985 the Delors Commission sought, unsuccessfully, to ensure that the Single European Act (signed in February 1986) would redefine the internal market in such a way as to put freedom of capital on the same footing as the other three freedoms. The legal basis for capital liberalization in Europe remained the same as it had been in 1957: "to the extent necessary."

The Delors Commission began in the spring of 1986 to formulate a plan for a series of directives to oblige member governments to liberalize unconditionally. Delors' first big step was a November 1986 directive that moved many of the capital transactions that the 1960 directive had placed on the conditional liberalization list to the unconditional list. In June 1988 the final capital movement directive 88(361) was issued. No capital transaction or transfer was exempt from this new obligation to liberalize. The Treaty of Rome qualifier, "to the extent necessary," was from the summer of 1988 onward defined such that all capital movements were "necessary" for the proper functioning of the common market.²⁶

Bakker observes that French "support of the liberalization process was decisive."²⁷ A variety of reasons led the French government in Paris and Delors Commission in Brussels to embrace the liberalization of capital as an obligation of membership in Europe. First, the French had already moved decisively in the direction of an open capital account. Although much remained to be liberalized in the middle of the 1980s, many French policy makers felt that complete liberalization was just a matter of time. More positively, French liberalization reflected a fundamental victory for the minority of modernizers and liberalizers who had long sought to reorient the Left toward the market and safeguard the value of the French currency. Delors recalls that it "was difficult to convince those in Paris," adding: "Many French politicians on both the Left and the Right were against the liberalization of capital." Nor did Delors win the day alone. Mitterrand himself played a critical role: "The firmness of the position of the

²⁵ Andrew Moravcsik, *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht* (Ithaca, N.Y.: Cornell University Press, 1998), pp. 361-362.

²⁶ See Bakker, *The Liberalization of Capital Movements*, p. 211; and Oliver and Baché, "Free Movement of Capital," pp. 66-67.

²⁷ Bakker, *The Liberalization of Capital Movements*, p. 212. See also Julius W. Friend, *The Long Presidency: France in the Mitterrand Years, 1981-1995* (Boulder, Colo.: Westview, 1998), pp. 191-192; and Jacques Melitz, "Financial Deregulation in France," *European Economic Review*, vol. 34, nos. 2-3 (1990), pp. 394-402, at pp. 294-295.

President of the Republic was decisive,” according to Delors. “No one has emphasized sufficiently the firmness of the President’s view that the French people prefer to be satisfied with the strength of their currency, indeed to be proud of their currency. This was an end in itself for the French government.”²⁸

Second, a *quid pro quo* with Germany, which had long supported the liberalization of European capital movements, promised to increase the symmetry of the European Monetary System (EMS) of fixed exchange rates. The 1987 Basle/Nyborg agreement to reduce the asymmetry in adjustment and management of speculative pressure was the German offer for French support of capital liberalization.²⁹ By securing the support of the French government, Basle/Nyborg paved the way for Delors to take the final step toward the codification of the capital mobility norm in Europe.

Third, perhaps even more profound than Delors’ political sense of the mood in Europe was his own growing conviction that the internal logic of the single market simply required free capital movements in a way that he had not foreseen even in 1985: “Although I had concerns, I came to the realization that the free movement of capital was essential to the creation of the internal market.”³⁰ As Lamy reflects, “The capital liberalization directive was not announced in 1985, and was not a part of the road map for 1992, because it was not yet conceived. Delors hesitated quite a lot. But the coherence of the plan as it evolved, the logic of the internal market, was powerful.”³¹ Once the plan was decided, in December 1985 and January 1986, Delors was convinced that capital liberalization would “have a psychological effect, creating a powerful signal – even more because the proposal was coming from the French.”³²

The fourth, most subtle and strategic reason was the one on which the preferences of the French government and the Delors Commission overlapped most. The Commission’s strategy, according to Nicolas Jabko, laid the very foundation for monetary union.³³ Both the French government and Delors saw the liberalization of capital movements as the first step in a sequence of events that would culminate in monetary union in Europe. The French interest in monetary union intensified with the adoption of the *franc fort*, the strong franc policy, that followed Mitterrand’s decision not to devalue and to remain within the EMS. This meant shadowing German monetary policy ever more closely, and the Bundesbank’s independence of everyone, including the German government, meant that there would be little outside influence on monetary

²⁸ Author’s interview with Delors.

²⁹ Bakker, *The Liberalization of Capital Movements in Europe*, pp. 191-194.

³⁰ Author’s interview with Delors.

³¹ Author’s interview with Lamy.

³² Author’s interview with Delors.

³³ Nicolas Jabko, “In the Name of the Market: How the European Commission Paved the Way for Monetary Union,” *Journal of European Public Policy*, vol. 6, no. 3 (1999), pp. 475-495.

policy making for all of Europe.³⁴ For Delors, Economic and Monetary Union (EMU) became a priority, and laying the foundations for union promised to be as great a feat as any Commission president had ever achieved. “EMU, more than everything else,” George Ross writes, “was Delors’ baby.”³⁵ Delors recalls the role of these “other politics as well.” 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.”³⁶

The path from the 1988 directive to monetary union was, Delors and his staff realized, long, and the strategy was in many ways extremely risky, for it threatened to unravel the EMS altogether. But the strategy also, Jabko observes, “was politically quite shrewd.”³⁷ The risk was that inflation rates among European countries would continue to diverge, even as exchange rate realignments within the EMS were becoming less frequent. Commission officials, Jabko notes, were “acutely aware of the economic incompatibility between fixed exchange rates, freedom of capital movements, and national policy autonomy.”³⁸

On the other hand, the strategy produced a logic that would appear irresistible, and a path that was inexorable, to governments in Europe. With a single capital market and fixed exchange rates there could be no place for autonomous monetary policy making in Europe. Europe’s central banks had already essentially relinquished their monetary autonomy to the Bundesbank through the working of the EMS. The Commission thus “raised the political stakes of EMU, acting decisively to liberalize capital movements while exhorting European governments to embrace EMU as a compensatory instrument for regaining monetary sovereignty.”³⁹

Thus, as Lamy recalls, the “ultimate goal” was monetary union:

Two logics were critical. Tommaso Padoa-Schioppa, who played a critical role among the plotters, outlined what we then called the Padoa-Schioppa theorem on the incompatibility of fixed exchange rates, capital mobility, and monetary policy autonomy. The Delors plan thus promised to spill over from capital

³⁴ Fixed exchange rate regimes operate asymmetrically by creating pressure for governments with weaker currencies to adjust to the policies of those with stronger currencies. In the EMS the strength of the German mark resulted from the country’s low inflation rate, itself the focus of Bundesbank policy. Germany was thus the focal point of the EMS.

³⁵ George Ross, *Jacques Delors and European Integration* (New York: Oxford University Press, 1995), p. 80.

³⁶ Author’s interview with Delors.

³⁷ Jabko, “In the Name of the Market,” p. 481.

³⁸ Jabko, “In the Name of the Market,” p. 479.

³⁹ Jabko, “In the Name of the Market,” p. 475.

movements to monetary integration. We also needed to erode German resistance, and capital freedom was the price to pay.⁴⁰

A concrete plan for EMU followed hard upon, and as a direct result of, the capital liberalization directive. French support for the 1988 directive was critical according to Craig Parsons: “Only when they accepted full capital mobility, in June 1988, did Kohl agree to create a committee on EMU under Commission President Delors.”⁴¹ The committee’s report, known as the Delors Report, helped to re-launch the EMU project. Indeed, the report’s outline became, with few modifications, the very text of the Treaty of Maastricht’s provisions for progressing toward EMU.⁴² Maastricht thus constituted the codification of the commitment of the French Left to a European project based definitively on market integration.⁴³ “The victory of the community project was not determined solely in France,” Parsons writes, “but the key battle of European ideas occurred there.”⁴⁴

The Château and Henri Chavranski

Membership in the OECD is only for the privileged.⁴⁵ It is, in a word, for the rich, symbolic of having achieved the status of “developed” country. The organization’s headquarters are in the sixteenth arrondissement of Paris, among the quiet, posh neighborhoods of old money, in the elegant Château de la Muette. The atmosphere of la Muette, as it is known, is dignified and serene, as befits the members of one of the most influential, private, and exclusive international organizations in the world.

The most consequential obligation of OECD membership is adherence to its Code of Liberalization of Capital Movements. Adherence is non-negotiable, and its commitments are taken quite seriously. Until the European Commission’s 1988 directive the Code was the only multilateral instrument that promoted the liberalization of capital movements.

When established in 1961, the Code of Liberalization excluded short-term capital movements on principle. The origin of the Code’s obligations had much in common

⁴⁰ Author’s interview with Lamy.

⁴¹ Craig Parsons, *A Certain Idea of Europe* (Ithaca, N.Y.: Cornell University Press, 2003), p. 205.

⁴² Amy Verdun, *European Responses to Globalization and Financial Market Integration: Perceptions of Economic and Monetary Union in Britain, France, and Germany* (New York: Palgrave, 2000), pp. 80-86.

⁴³ Sophie Meunier, “Globalization and Europeanization: A Challenge to French Politics,” *French Politics*, vol. 2, no. 2 (2004), pp. 125-150.

⁴⁴ Parsons, *A Certain Idea of Europe*, p. 2.

⁴⁵ On the meaning of OECD membership see especially Henri Chavranski, *L’OCDE: Au coeur des grands débats économiques* (Paris: La documentation française, 1997), p. 7.

with that of the Treaty of Rome. Both documents were founded amid profound mistrust of short-term capital movements. According to Raymond Bertrand, who spent much of his career in a senior post in the OECD Secretariat, the Code's obligations were limited to long-term capital flows, particularly foreign direct investment, as a matter of self-reflective purpose. The omission of short-term capital, he writes, "stems from the recognition that short-term financial transactions, in particular those initiated by banks, can pose problems for the management of money and of exchange reserves, especially under fixed or managed exchange rates."⁴⁶ For more than forty years the OECD's Committee on Capital Movements and Invisible Transactions (CMIT) oversaw amendments to and members' compliance with the Code.

On each occasion that an extension of the Code's obligations to new capital transactions was discussed in the CMIT the Europeans, especially, worried about "hot money." When the Code was first amended in 1964, the OECD, according to the Secretariat's Pierre Poret, "took an explicit decision not to extend the scope of the Code to short-term operations on the grounds that their liberalization would make their balances of payments vulnerable to shifts in market participants' sentiments and compromise the independence of their economic policies."⁴⁷ During the late 1960s the United States urged its OECD colleagues to embrace capital liberalization. Its suggestions were met with reluctance and, in the case of France, with outright opposition.⁴⁸ The 1973 amendment was again quite modest, adding only collective investment services. By the early 1980s members of the CMIT were discussing means to strengthen the Code's stance on foreign direct investment. Consensus was reached quickly; in 1984 the Code's jurisdiction over foreign direct investment was amended to include the right of establishment for non-resident investors.

The CMIT spent the balance of the 1980s working toward a consensus in favor of the liberalization of all capital movements. Eventually the French joined this consensus, eagerly, and in 1989 the Code was amended one last time to include all capital movements. The single most influential policy maker during the CMIT's evolution was Henri Chavranski, the chair of the Committee from 1982 until 1994 and a member of the French delegation to the OECD. One of the central, but under-appreciated stories of globalization is that of the Code of Liberalization of Capital Movements, the CMIT, and

⁴⁶ Raymond Bertrand, "The Liberalization of Capital Movements – An Insight," *Three Banks Review*, no. 132 (1981), pp. 3-22, at p. 3.

⁴⁷ Pierre Poret, "The Experience of the OECD with the Code of Liberalization of Capital Movements," Paper presented at an IMF seminar on Current Legal Issues Affecting Central Banks, May 1998, p. 5.

⁴⁸ See Jeffrey R. Shafer, "Experience with Controls on International Capital Movements in OECD Countries: Solution or Problem for Monetary Policy?" in *Capital Controls, Exchange Rates, and Monetary Policy in the World Economy*, ed. Sebastian Edwards (Cambridge: Cambridge University Press, 1995), p. 123ff.

the convergence of European finance ministers to a worldview that enshrined the freedom of capital movements.

The late 1980s was a period of profound change for the OECD, in la Murette as well as in the members' capitals. Many OECD members had begun to dismantle their capital controls regimes unilaterally. The legal foundations for central bank independence were being laid in member countries in which they were not already in place. A decisive shift away from policy discretion was underway. Chavranski recalls,

What the CMIT experienced during my tenure was a pendulum swing in sentiment about markets. The Europeans had no answer to the Reagan-Thatcher thesis, and so we followed. The process was most dramatic in France. The French position in the OECD had always been to slow down the expansion of the Code of Liberalization. When the French position changed in the middle of the 1980s, the CMIT could begin its work toward a truly liberal Code.⁴⁹

Forty years of contention over short-term capital flows in la Murette resolved into the calm and consensual tenor of the CMIT discussions of a new obligation. "There was no strong opposition to the expansion of the Code," according to Chavranski. "A few countries were reluctant, but there was no big fight. The idea was accepted."⁵⁰ By the late 1980s the United States no longer needed to take the lead in expanding the liberalization obligations of the Code. As Jeffrey Shafer recalls,

I always recognized that one could have sympathy for the objectives of the Left and believe that liberalization was, given the context of the international economy, the best way to achieve them. Important figures in the European Left came around to this view, and it ultimately influenced OECD practice in a number of areas, including capital account liberalization. I often advised the Treasury not to push or be especially vocal in OECD debates about liberalization. Just be quiet and let the impetus come from the Secretariat and the Europeans who are supportive.⁵¹

As had Jacques Delors before him with respect to the 1988 directive, Chavranski, as CMIT chair, did not succeed in amending the Code by running too far ahead of his OECD colleagues. Rather, he engaged members who had for some time been enthusiastic about bringing short-term capital within the legal mandate of the Code.

⁴⁹ Author's interview with Chavranski.

⁵⁰ Author's interview with Chavranski.

⁵¹ Author's interview with Jeffrey R. Shafer, Counsellor for International Economic Policies, Deputy Director of the General Economics Branch, and Deputy Director of the Country Studies Branch, Economics Department, OECD [1984-1993], Assistant Secretary for International Affairs, U.S. Treasury [1993-1995], Under Secretary for International Affairs, U.S. Treasury [1995-1997], New York, August 12, 2004.

According to the Swede Jan Nipstad, who chaired the working group formed to champion the expansion of the Code, Chavranski's support was "masterly." A relatively recent convert to the cause of capital liberalization, Nipstad worked closely with Chavranski to bring about consensus within the CMIT. Together with France's new embrace of liberalization, the reasoned support of one known *not* to be dogmatically liberal greatly enhanced the legitimacy of the expansion among members who were still skeptical. Chavranski's role, Nipstad insists, was "essential" to the success of the proposal.⁵²

OECD members agreed to a new standard of appropriate policy practice in 1989. Capital liberalization had become the usual behavior of OECD members. In 1989 OECD members agreed that an open capital account was to be one of the defining – the constituting, the proper – practices of a "developed" country: "While member countries are clearly at different stages of liberalization, they now share the view that the complete liberalization of capital movements is a proper goal."⁵³ What the OECD's amendment did, by Louis Pauly's assessment, was begin "to replace the formal legal right to control capital movements with a new right. The effort to codify the norm of capital mobility," he added, "continues."⁵⁴

The Fund and Freedom under Michel Camdessus

By 1990 the institutional foundations of the internationalization of finance among European and developed countries had been laid. The rules had been written primarily by French policy makers. The only institutional void in the architecture of globalization was the codification of capital mobility in a truly global organization.

The effort within the IMF to codify the norm of capital mobility was a phenomenon of the middle of the 1990s. Until 1987, under the leadership of Managing Director Jacques de Larosière, Fund management intended that the organization stand apart from the process of financial internationalization. "We had our catechism," explained de Larosière:

'Thou must give freedom to current payments, but thou must not necessarily give freedom to capital.' I was comfortable with the idea that the Fund would not move toward compulsory freedom of capital. By the time I left the Fund in

⁵² Author's interview with Jan Nipstad, Chair of the OECD Joint Working Group on Banking and Related Financial Services [1985-1989], Stockholm, April 22, 2004.

⁵³ "Banking and Financial Services: Review and Proposed Amendment of the Codes of Liberalization of Capital Movements and Invisible Operations," p. 8, Committee on Capital Movements and Invisible Transactions and Committee on Financial Markets, February 14, 1989, DAF/INV/89.4 and DAF/MC/SF/89.1 (OECD Archives).

⁵⁴ Louis W. Pauly, *Who Elected the Bankers? Surveillance and Control in the World Economy* (Ithaca, N.Y.: Cornell University Press, 1997), p. 37.

1987 I was not aware of any discussions of changing the Articles to bring the capital account within our jurisdiction.⁵⁵

The proposed amendment clearly emerged within the Fund after de Larosière returned to Paris and Michel Camdessus arrived in Washington as the new Managing Director, a post he held between 1987 and 2000. Camdessus first formally proposed the amendment to the Fund's Executive Board in 1995, though the idea had been considered within Fund management as early as 1994.

Many Fund critics viewed the proposed amendment as the final step toward the complete codification of liberalism in the international financial system. The critics presumed Fund management to be doing the bidding of the U.S. Treasury, which in turn must have been following the orders of the big banks on Wall Street. But neither was true. As Charles Dallara, Managing Director of the Institute of International Finance, insists, "The proposal was by no means a Treasury or Wall Street initiative."⁵⁶

Indeed senior officials at the U.S. Treasury were indifferent to the proposed amendment, though not because they opposed liberalization in principle. "The idea," a former senior Treasury official argued, "that the Fund was doing the bidding of the Treasury to push openness is totally wrong." The proposal, the official argued, "came from the Fund. It didn't come from us." There was no one at Treasury with a portfolio that included shepherding the amendment through the Fund and beyond. The proposal, in Treasury lingo, "didn't get adult supervision."⁵⁷ As former Treasury Secretary Lawrence Summers recalls, "I gave very little attention to the issue; Rubin gave it less."⁵⁸

Wall Street, represented in Washington by the Institute of International Finance, was opposed to the proposal altogether.⁵⁹ According to Lex Rieffel, a former Treasury

⁵⁵ Author's interview with Jacques de Larosière, Managing Director of the International Monetary Fund [1978-1987], Paris, April 21, 2004.

⁵⁶ Author's interview with Charles H. Dallara, Managing Director, Institute of International Finance, Washington, D.C., May 26, 2004.

⁵⁷ Author's interview with a former senior U.S. Treasury official, Washington, D.C., October 6, 2003.

⁵⁸ Author's interview with Lawrence Summers, Deputy Secretary of the Treasury [1995-1999] and Secretary of the Treasury [1999-2001], Cambridge, Mass., April 30, 2004.

⁵⁹ This position was first articulated in *Capital Account Convertibility as an IMF Obligation: A Briefing Note for the IIF Board of Directors*, unpublished memorandum, Institute of International Finance, Washington, D.C., September 9, 1997. In the spring of 1998 the IIF's Managing Director wrote a letter to Philippe Maystadt, Chairman of the IMF's Interim Committee noting that "the case has not yet been made that an amendment of the IMF Articles is necessary," and reemphasizing the dangers of premature capital liberalization. Letter from Charles H. Dallara,

and OECD official who chaired the Working Group on capital account liberalization at the Institute, it is important to distinguish between the freedom of capital movements and the proposed amendment to the Fund's Articles: "Of course, Wall Street was in favor of liberalization," he explained. "But the financial community had some serious reservations about giving the Fund jurisdiction over the capital account."⁶⁰ These reservations included the fear that the amendment would legitimize the capital controls the Fund did approve.

The Working Group held three meetings during which the 22 members solidified their positions and clarified the opposition of the private financial community. Weighing the arguments in favor and against, the Working Group "found sufficient reason for the private financial community to oppose at this time any amendment that would formally extend the jurisdiction of the IMF over capital movements."⁶¹

Dallara recalls that his colleagues "sympathized with bankers from emerging markets who warned against premature liberalization and the vulnerabilities that came with it. Although capital account openness," he continued, "is in the broad interest of financial institutions, bankers are much more interested in particular countries, rather than the system as a whole. And the economies that matter most are already mostly open."

Lastly, Dallara reflected on the private sector's lack of

confidence in the Fund's ability to see both the public and the private interest. The culture of the Fund is almost always to see the public interest in any situation. The proposed amendment was an example: although the proposal was exactly at the intersection of public and private, in formulating its approach the Fund consulted with the private sector virtually not at all.⁶²

The idea to amend the Articles, Camdessus recalls, "came from within the Fund."⁶³ By all accounts the proposal was formulated and promoted by Camdessus

Managing Director of the Institute of International Finance, to His Excellency, Minister Philippe Maystadt, Chairman of the Interim Committee, April 8, 1998.

⁶⁰ Author's interview with Lex Rieffel, Brookings Institution, Washington, D.C., May 25, 2004.

⁶¹ *IIF Working Group on the Liberalization of Capital Movements: Final Report*, unpublished memorandum, Institute of International Finance, Washington, D.C., January 20, 1999, p. 22. Such clear language is also in *IIF Working Group on the Liberalization of Capital Movements: Executive Summary*, unpublished memorandum, Institute of International Finance, Washington, D.C., January 20, 1999, p. v.

⁶² Author's interview with Dallara.

⁶³ Author's interview with Michel Camdessus, Managing Director of the International Monetary Fund [1987-2000], Paris, April 19, 2004.

himself. Jack Boorman, then Director of the powerful Policy Development and Review Department, maintains that Camdessus was the “driving force” behind the amendment.⁶⁴ And former Executive Director Thomas Bernes recalls that the proposal originated with Camdessus, the amendment being “part of Camdessus’ vision for the Fund.”⁶⁵

Camdessus argues that he was applying lessons he learned in the Mitterrand administration:

Exchange controls may help insulate a country’s authorities, but only for a very short time. Even the best conceived and effective exchange control system will be circumvented within six months. Speculators and crooks are extremely sophisticated. And then, after a year, exchange controls are effective only against the poor. The French experience of the beginning of the ‘80s had been extremely convincing for me. I preached on every possible occasion that you cannot trust exchange controls in the long term.⁶⁶

For Camdessus and Fund management, the principle of the amendment was to adjust the Fund’s authority to a global economy, a world in which capital flows vastly exceeded trade flows. “The IMF’s role,” according to Camdessus, “would be to help countries adapt to a new world.”⁶⁷ Camdessus and Fund management were surprised to discover that so many did not trust them with jurisdiction over the capital account.

Wall Street and the Treasury perceived the Fund’s management to be desperately attempting to make the IMF more relevant to globalization. Summers called the proposal “a bureaucratic imperative.”⁶⁸ Dallara construed it to be an attempt by the Fund to “enhance its role in the international financial system, to bring it back to the center of the financial universe, where it had not been for some time. The Fund had been increasingly marginalized,” according to Dallara, “and the Fund’s management appeared eager to play a more important role.”⁶⁹

The proposal to amend the Fund’s Articles almost succeeded. Emboldened by the financial crisis in Asia, however, a number of developing country Directors on the organization’s Executive Board began actively to oppose the amendment in the spring of 1998. The possibility of a capital account amendment was destroyed ultimately by the

⁶⁴ Author’s interview with Jack Boorman, Director, Policy Development and Review Department, International Monetary Fund [1990-2001], Washington, D.C., September 23, 2003.

⁶⁵ Author’s interview with Thomas A. Bernes, Executive Director, International Monetary Fund [1996-2001], Washington, D.C., October 16, 2003.

⁶⁶ Author’s interview with Camdessus.

⁶⁷ Author’s interview with Camdessus.

⁶⁸ Author’s interview with Summers.

⁶⁹ Author’s interview with Dallara.

U.S. Congress, when, in May 1998, powerful Democrats in the House of Representatives threatened to withhold support for an increase in the U.S. contribution to the Fund if the Treasury did not withdraw all U.S. support for the amendment.⁷⁰ The U.S. Treasury immediately ended its already meager support. Without U.S. support, not to mention a G-7 consensus, no proposal for such a dramatic change in the international financial architecture had a chance. With only a few European Executive Directors still in favor of the proposed amendment, Camdessus and Fund management were left without even the most putatively natural allies of the codification of capital's freedom worldwide.

Heresy, Orthodoxy, and the Informal Rules of Globalization

International monetary affairs seem to encourage policy makers and scholars to adopt the evocative language of religion: dogma, heresy, orthodoxy, doctrine, reformation. One reason for this hyperbole is that the relationship between the content of the written and unwritten rules has changed dramatically more than once. Another is that the written rules cannot sufficiently convey how the international monetary system functions. Because the informal rules exist only as the collective understandings of policy makers and markets, such shared beliefs are often held strongly. In an already classic essay economist Ronald McKinnon, adopting a phrase Keynes had once used to elaborate the principles that governed the gold standard, described the "rules of the game" for each of the international monetary orders of the last one hundred and twenty years. McKinnon described both formal rules and informal, "implicit rules."⁷¹ The place of capital controls in the post-war orders is illustrative. McKinnon characterizes the "spirit" of the Bretton Woods agreement thus: "Free currency convertibility for current-account payments; use capital controls to dampen currency speculation." The "floating-rate dollar standard," 1973-1984, however, was defined in part by a new rule: "Free currency convertibility for current payments, while eventually eliminating remaining restrictions on capital account."⁷² In a similar vein, economist Robert Mundell wrote of the "framework of laws, conventions, regulations, and mores that establish the setting of the system and the understanding of the environment by the participants in it."⁷³

⁷⁰ Letter to the Honorable Robert E. Rubin, Secretary, Department of the Treasury, from Reps. Richard Gephardt, David Bonior, Nancy Pelosi, Barney Frank, Maxine Waters, and Esteban Edward Torres, May 1, 1998. See www.house.gov/frank/imf-letter.html.

⁷¹ 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, esp. pp. 2-3.

⁷² McKinnon, "The Rules of the Game," p. 13, Rule Box 2, and p. 29, Rule Box 4.

⁷³ Robert A. Mundell, "The Future of the International Financial System," in *Bretton Woods Revisited*, ed. A. L. K. Acheson, J. F. Chant, and M. F. J. Prachowny (Toronto: University of Toronto Press, 1972), p. 92.

Three informal institutions influenced this emerging era of global capital. First, international organizations have sometimes shifted their practices without a formal change in rules. In the OECD, for example, the CMIT interpreted the Code of Liberalization less strictly after the international financial crises of 1997 and 1998. An informal shift in IMF policy was also consequential. In the absence of a formal mandate to promote capital liberalization the Fund began, during the late 1980s and early 1990s, to encourage members to liberalize. IMF management, especially, sought to define the organization's unofficial doctrine as liberal, even before it sought to amend the Articles.⁷⁴ Although the Fund's area departments did not promote or advise liberalization systematically, it is clear that IMF practice shifted under the leadership of Managing Director Camdessus.⁷⁵

Second, the beliefs of market participants are a critical determinant of the consequences of capital controls.⁷⁶ An ideological consensus, argue Beth Simmons and Zachary Elkins, "alters the reputational payoffs associated with policy choice."⁷⁷ Market participants infer meanings from policies. Economists have, following this logic, described capital controls and liberalizations as important signals to the markets: liberalizations signal good, restrictions signal bad policies.⁷⁸ "Imposing controls on the capital account," observes Geoffrey Garrett, "also sends signals to mobile capital that the country imposing the restrictions is in important senses unfriendly."⁷⁹ What is perhaps most remarkable about the signaling content of capital controls – the inference that the

⁷⁴ See Jonathan Kirshner, "Explaining Choices About Money," in *Monetary Orders*, ed. Kirshner, pp. 270-279; and Joseph E. Stiglitz, "Capital-Market Liberalization, Globalization, and the IMF," *Oxford Review of Economic Policy*, vol. 20, no. 1 (2004), pp. 57-71.

⁷⁵ See Independent Evaluation Office of the International Monetary Fund, *The IMF's Approach to Capital Account Liberalization* (Washington, D.C.: International Monetary Fund, forthcoming).

⁷⁶ On the content and influence of the prevailing orthodoxy, see Ilene Grabel, "Ideology, Power, and the Rise of Independent Monetary Institutions in Emerging Economies," in *Monetary Orders*, ed. Kirshner. Also see Grabel, "Creating 'Credible' Economic Policy in Developing and Transitional Economies," *Review of Radical Political Economics*, vol. 29, no. 3 (1997), pp. 70-78; and Grabel, "The Political Economy of 'Policy Credibility': The New-Classical Economics and the Remaking of Emerging Economies," *Cambridge Journal of Economics*, vol. 24, no. 1 (2000), pp. 1-19.

⁷⁷ 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 p. 172-173.

⁷⁸ 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. Also see 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.

⁷⁹ Geoffrey Garrett, "The Causes of Globalization," *Comparative Political Studies*, vol. 33, nos. 6/7 (2000), pp. 941-991, at p. 975.

market is supposed to draw from their imposition – is that the content changed so much between the 1950s and 1990s.

Third, although the beliefs of the financial markets are not always easily measured, the beliefs of managers and analysts in three firms – the credit rating agencies S&P, Moody’s, and Fitch – provide an informative window into how specific policies are interpreted by financial markets.⁸⁰ These firms’ ratings of sovereign issuers and their debt, and the explanations advanced to justify changes in ratings, are profoundly consequential for contemporary international capital markets.⁸¹ Although the rating agencies play no formal role in the design of the international monetary system, the mediation of the rating agencies – given teeth by worldwide incorporation of ratings into national regulations – has become so important to the issuing of sovereign debt that it is no longer possible to understand the governance of debt markets without elucidating the agencies’ influence. The views of S&P and Moody’s (the so-called Big Two) effectively bridge the formal and informal institutions of the international monetary system. By 2005 S&P and Moody’s each rated more than 100 sovereigns, between them accounting for 90 percent of the sovereign ratings market.

Because the rating agencies necessarily attempt to assess the effect of policies in a way that both conditions and reflects the reactions of the markets, their analysts must make judgments about the signals policies convey and the inferences markets will draw from them. As David Levey, Managing Director of Sovereign Risk at Moody’s for nearly twenty years, observes, “Ratings necessarily rely on a predominantly qualitative methodology. It is all a matter of interpretation.” Although Moody’s analysts sought not to impose their ideologies on their judgments, they also recognized that capital liberalization came to be seen as “a certain inevitability, and appeared to become international dogma.”⁸² S&P’s sovereign analysts, for their part, seemed to reflect and reinforce the prevailing market views, emphasizing that higher-rated sovereigns embrace “orthodox market-oriented economic programs.”⁸³ S&P’s Marie Cavanaugh

⁸⁰ An excellent qualitative and quantitative analysis of the beliefs of financial market participants and their interaction with developed and emerging-market economies is Layna Mosley, *Global Capital and National Governments* (Cambridge: Cambridge University Press, 2003).

⁸¹ 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); Richard Sylla, “An Historical Primer on the Business of Credit Rating,” in *Ratings, Rating Agencies, and the Global Financial System*, ed. Richard M. Levich, Giovanni Majnoni, and Carmen Reinhardt (Boston: Kluwer, 2002); and Timothy J. Sinclair, *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness* (Ithaca, N.Y.: Cornell University Press, 2005).

⁸² Author’s interview with David Levey, Managing Director, Sovereign Risk, Moody’s Investors Service [1986-2004], New York, February 4, 2005.

⁸³ Marie Cavanaugh, *Sovereign Credit Characteristics by Rating Category* (New York: Standard & Poor’s, November 19, 2003).

also emphasized the shared “basic economic orthodoxy” among the members of a rating committee.⁸⁴

One critical issue, therefore, is the extent to which rating agencies anticipate or follow the markets on whose behalf they analyze sovereigns. Some scholars have found that upgrades have followed market rallies, while downgrades followed market downturns – and still the markets react to the new ratings. This finding suggests a fascinating problem with the market discipline represented by the agencies: not only are the agencies obliged to reflect the beliefs of the markets in an age of potentially self-fulfilling expectations, to the extent that ratings are a lagging indicator of creditworthiness the agencies help to create procyclical movements of capital.⁸⁵

Moody’s and S&P thus participate in the construction of beliefs within the financial markets, self-consciously attempt to incorporate those beliefs into their analysis of the likely responses of markets to a policy change, and, in a sense, have been informally delegated the responsibility of monitoring such policy changes by market participants. Some policy makers have also formally delegated to rating agencies responsibility for monitoring sovereigns by incorporating ratings into the financial regulations of the United States, as well as in many other countries around the world. What has come to be called the “private authority” of the rating agencies has in fact been increasingly and overtly public, less informal and more codified, over time.⁸⁶ Policy makers in Europe and in developing countries have increasingly criticized these firms as mechanisms through which distinctively American borrowing and lending practices are diffused throughout the world. This criticism applies less directly to sovereign debt markets, but still the agencies are often seen to represent the worldview shared among members of the American private financial community.

One now-famous instance in which the rating agencies appeared to reproduce the prevailing orthodoxy about capital liberalization occurred during the Asian financial crisis, and in particular, when the Malaysian government began its experiment with restrictions on capital outflows during September 1998. Observers sometimes point to the Malaysian experience, and the international condemnation of the capital controls, as

⁸⁴ Quoted in Abdelal and Bruner, *Private Capital and Public Policy*, p. 7. Marie Cavanaugh is Managing Director, Sovereign Ratings, Standard & Poor’s.

⁸⁵ See Graciela Kaminsky and Sergio Schmukler, “Rating Agencies and Financial Markets,” in *Ratings, Rating Agencies, and the Global Financial System*, ed. Levich, Majnoni, and Reinhardt, p. 229; Helmut Reisen and Julia von Maltzan, “Boom and Bust in Sovereign Ratings,” *International Finance*, vol. 2, no. 2 (1999), pp. 273-294; and G. Ferri, L-G. Liu, and J. E. Stiglitz, “The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis,” *Economic Notes*, vol. 28, no. 3 (1999), pp. 335-356.

⁸⁶ Christopher M. Bruner and Rawi Abdelal, “To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy,” unpublished ms., Harvard Business School, January 2005.

the epitome of the agencies' enforcement of orthodoxy. But the agencies' approach both before and since the crisis suggests an alternate interpretation. By the middle of the 1990s all EU and OECD countries had fully liberalized capital flows; both the informal and formal rules were clear. The debate over the proposed amendment to the IMF's Articles was still contentious, and many financial market participants believed that the norm of capital mobility ought to be expanded in scope to apply to developing as well as to developed countries, and in times of crisis as much as in moments of relative stability. 1998 was the high point of these unreservedly liberal views about capital controls.

The Malaysian government's decision to impose capital controls during the crisis was thus a defining moment in the contemporary policy debate on capital liberalization. The reaction of the international financial community was harsh. Investors, such as emerging markets guru Mark Mobius, called the controls "a disaster." A number of economists agreed, including Nobel laureate Merton Miller, who called the controls "a failure, and one whose costs will be borne by the Malaysian people for many years to come." *Business Week's* editors likened the controls to "a financial Roach Motel."⁸⁷ The economist Paul Krugman, though he supported the Malaysian government's experimentation, noted the "radical" character of capital controls and later wrote of "how Malaysia got away with economic heresy."⁸⁸

Malaysian officials anticipated some of the criticism they received, but not the serious consequences of the disapproval of Fitch, Moody's, and Standard & Poor's. All downgraded Malaysia's sovereign risk rating, citing in their reports the capital controls as the primary reason. Fitch went the furthest in its downgrade, dropping Malaysian government debt below investment-grade, to "junk bond" status. Explained a Fitch spokesperson, "We are in no doubt about Malaysia's ability to service its debt. It is a question of willingness to do so. If Malaysia can change rules in an arbitrary fashion once, it can do so again."⁸⁹ Standard & Poor's cited the "dramatic deterioration in the policy environment," and warned that the "imposition of controls also signaled a major shift in policy." Although Malaysia's sound fundamentals – a "still-moderate external debt burden and adequate international liquidity" – kept its government debt investment-grade, the agency's outlook was negative. "Additional heterodox measures

⁸⁷ See Rawi Abdelal and Laura Alfaro, *Malaysia: Capital and Control*, Harvard Business School Case 702-040 (2002), pp. 2, 12-13.

⁸⁸ Paul Krugman, "Saving Asia: It's Time to Get Radical," *Fortune*, vol. 138, no. 5 (1998), pp. 74-80; and Krugman, "Capital Control Freaks: How Malaysia Got Away with Economic Heresy," *Slate*, September 27, 1999.

⁸⁹ Quoted in Abdelal and Alfaro, *Malaysia: Capital and Control*, p. 12.

by the government," Standard & Poor's cautioned, "would prompt a downgrade to non-investment grade."⁹⁰

These reactions revealed a great deal about the emerging consensus on capital mobility in 1998, a consensus that has since been shattered. There was no written rule in the international monetary system that the Malaysian government violated. Malaysia was not obliged by its membership in any international organization to refrain from regulating capital movements either into or out of the country. And yet it was clear that the Malaysian government's stance toward the international financial markets had violated an unwritten rule – one of the norms – of globalization.⁹¹ These unwritten rules continue to evolve.

The Paris Consensus, the Reunion of Ricardo and Marx, and the Rise of Global Capital

The scholarly literature on the internationalization of capital has grown large, and rightly so given the importance of the topic. The arguments and findings of this book require, however, several significant revisions to the conventional wisdom about the political economy of the rise of global capital markets. First, although the United States promoted globalization, it did so unilaterally; the United States neither proposed nor enthusiastically endorsed the attempts to codify the norm of capital mobility within international organizations. The newly liberal rules of the globalization of finance were written in Europe by Europeans who shared the consensus that favored of liberalization. Second, although the rhetoric of the European Left during the past two decades has largely been that of capitulation to the forces of global capital, politicians and parties of the Left throughout Europe in fact embraced, for diverse reasons, to be sure, liberal rules for capital flows.

Third, scholars and policy makers have privileged a variety of changes that enabled capital to become more mobile: the advance of knowledge that capital liberalization is simply prudent, growth-oriented policy, bolstered by the common refrain that capital controls "do not work"; the end of system-wide fixed exchange rates; and competitive deregulation, a sort of race to the bottom (or top, if one is a banker). There is an element of truth in each of these stories, and in the aggregate these influences have enabled capital to become more mobile. They are, as Beth Simmons argues,

⁹⁰ Standard & Poor's, "Malaysia's Ratings Cut by S&P; Outlook Still Negative," *Standard & Poor's CreditWire*, September 15, 1998.

⁹¹ For more on the controls and the prevailing beliefs of the international financial community, as well as the scholarly debate on the purposes and effects of the controls, see Rawi Abdelal and Laura Alfaro, "Capital and Control: Lessons from Malaysia," *Challenge*, vol. 46, no. 4 (2003), pp. 36-53.

complementary explanations for the internationalization of capital.⁹² But each of these accounts is also factually problematic, and even together they lack explanatory power. None does much to explain the fundamental change in the legitimacy and the signaling content of capital controls; nor do they help to explain the efforts of European policy makers to codify the norm of capital mobility. What is missing is an analytical perspective that explains how the formal and informal rules of globalization matter.

Locating the Consensus in Paris

Nearly all scholars of globalization maintain that the policy consensus that favored capital's freedom profoundly influenced the process of liberalization. Most scrutinized is the consensus that emerged in New York and Washington, D.C., that is, in the United States. This is natural; the United States is, after all, at the center of the international monetary system, and Wall Street financial firms and the U.S. Treasury have generally favored liberalization. So, Jagdish Bhagwati refers to the "Wall Street-Treasury complex," and Robert Wade and Frank Veneroso write of the "Wall Street-Treasury-IMF complex."⁹³ These arguments have not been applied systematically to the codification of capital mobility in the IMF or, indeed, in other international organizations. But it would be tempting to assume that the U.S. Treasury and Wall Street promoted such codification, and even that U.S. hegemony was most responsible for the rise of our current era of global capital, a phenomenon that has been favored by, and very much benefits, the United States. This would be a mistake, however. Not every liberal initiative in international finance has emanated from New York or Washington.

Although the U.S. promoted liberalization, it has done so unilaterally and bilaterally, and almost never multilaterally.⁹⁴ American unilateral liberalization helped to put pressure on other countries to follow suit, and the U.S. Treasury has increasingly encouraged states to liberalize on a bilateral basis, often promoting such clauses in bilateral treaties. But as evidenced by the story of the IMF during the 1990s, both Wall Street and the U.S. Treasury have essentially opposed, and at best were ambivalent about, the multilateral codification of the norm of capital mobility. Whereas the U.S.

⁹² Simmons, "The Internationalization of Capital," p. 43.

⁹³ Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs*, vol. 77, no. 3 (1998), pp. 7-12; and Bhagwati, *In Defense of Globalization* (Oxford: Oxford University Press, 2004), pp. 204-206; Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model versus the Wall-Street-Treasury-IMF Complex," *New Left Review*, no. 228 (1998), pp. 3-23; Wade and Veneroso, "The Gathering World Slump and the Battle Over Capital Controls," *New Left Review*, no. 231 (1998), pp. 13-42; and Wade, "The Fight Over Capital Flows," *Foreign Policy*, no. 113 (1998-99), pp. 41-54.

⁹⁴ Helleiner, *States and the Reemergence of Global Finance*, p. 99. The U.S. influence over the terms of the lending agreement between the IMF and South Korea may be an exception to this rule.

approach to globalization has been *ad hoc*, IMF management sought to institutionalize and multilateralize the rules of capital. The IMF amendment was one more episode in the struggle between the U.S. Treasury and the IMF to determine which would exercise more influence on the trajectory of financial globalization.⁹⁵

The Europeans were, moreover, not dragged along by the Americans toward a future of global capital. To the contrary, the Europeans led the way by creating the most liberal, and most consequential, rules of the system. It would have been pointless for the Americans to have preached liberalism to the Europeans, for they were already converted. The Europeans' "open regionalism" made globalization possible.⁹⁶ We should be analyzing the Wall Street-Treasury-French *Tresor*-Paris-Frankfurt-Brussels complex.

The globalization of finance is not best understood as a conspiracy at all, and certainly not one orchestrated by American policy makers and bankers. Indeed, on the rules of globalization the only truly decisive confluence of liberal worldviews was in Paris. The Paris consensus, not the Washington consensus, authored the rules of global capital. The best that the paranoid can reasonably imagine is a conspiracy of French liberals and socialists.

The Reunion of Ricardo and Marx

The story of liberalism in the financial markets of the developed world is not, as it is so often stylized, the capitulation of the European Left. The French Left did much more than find its will broken by the realities of globalization; many French socialists appear to have embraced the market wholeheartedly. At the end of the twentieth century the Left and Right in France, as in many other European countries, disagreed about practically everything, save finance. The situation was reminiscent of sociologist Karl Polanyi's description of the consensus on the gold standard: "Where Ricardo and Marx were as one, the nineteenth century knew not doubt."⁹⁷ On "the money issue," in Polanyi's words, of the twentieth century, the consensus of the Left and Right had led to the death of economic doubt, at least in the OECD, EU, and IMF. Estranged for nearly a century, Ricardo and Marx were reunited.

The liberal internationalism of the Left during the 1980s was not historically unique in France, nor even unusual in comparative context. It has a historical parallel in

⁹⁵ On this struggle in a previous episode see David E. Spiro, *The Hidden Hand of American Hegemony: Petrodollar Recycling and International Markets* (Ithaca, N.Y.: Cornell University Press, 1999).

⁹⁶ Peter J. Katzenstein, *A World of Regions* (Ithaca, N.Y.: Cornell University Press, forthcoming 2005).

⁹⁷ Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Times* (Boston: Beacon, [1944] 1957), p. 25.

the first era of globalization, which lasted roughly from 1880 until 1914. The French Left argued that workers abroad would improve their standard of living through trade. Political considerations also informed the Left's internationalism. "For the Left to realize its domestic political objectives," writes Suzanne Berger, "it needed to sustain a broad Republican coalition, and it understood that the platform on which such a coalition could be constructed required anti-protectionism and embrace of an open international economy."⁹⁸ One of the most telling stylized facts of our era of globalization is that episodes of market-oriented reforms have been implemented much more frequently by putatively left-wing governments than by those on the right.⁹⁹

Although much has been made of the rise of "neoliberalism," the role of the French and European Left in creating globalization suggests a need for a more nuanced understanding of the role of ideology in the diffusion of liberal policy practices. To be sure, neoliberalism did change the character of the policy debate. During the 1970s and 1980s, and associated with the rise of Margaret Thatcher in Britain and Ronald Reagan in the United States, a new policy consensus that differed from the embedded liberal compromise of the 1940s emerged.¹⁰⁰ Neoliberalism became dominant throughout the OECD and the EU. The OECD's Pierre Poret, for example, describes a "new era in policy attitudes" in the 1980s:

The priority objectives ascribed to monetary policies in OECD countries converged towards achieving long-term price stability, and, to this end, building up credibility-enhancing mechanisms. Capital controls, which had in the past aimed at preserving the ability of monetary policy to exploit a possible trade-off between inflation and unemployment, did not fit into this new policy paradigm and risked to distract the authorities from the essential task of maintaining sound and credible economic policies.¹⁰¹

⁹⁸ Suzanne Berger, *The First Globalization: Lessons from the French*, manuscript, p. 118, published as *Notre Première Mondialisation: Leçons d'un Echec Oublié* (Paris: Seuil, 2003).

⁹⁹ John Williamson and Stephan Haggard, "The Political Conditions for Economic Reform," in *The Political Economy of Policy Reform*, ed. John Williamson (Washington, D.C.: Institute for International Economics, 1994). Also see Alex Cukierman and Mariano Tommasi, "When Does it Take a Nixon to Go to China?" *American Economic Review*, vol. 88, no. 1 (1998), pp. 180-197; Cukierman and Tommasi, "Credibility of Policymakers and of Economic Reforms," in *The Political Economy of Reform*, ed. Federico Sturzenegger and Mariano Tommasi (Cambridge, Mass.: MIT Press, 1998); and Dani Rodrik, "Promises, Promises: Credible Policy Reform via Signalling," *The Economic Journal*, vol. 99, no. 397 (1989), pp. 756-772.

¹⁰⁰ See Peter A. Hall, "The Movement from Keynesianism to Monetarism," in *Structuring Politics: Historical Institutionalism in Comparative Analysis*, ed. Sven Steinmo, Kathleen Thelen, and Frank Longstreth (Cambridge: Cambridge University Press, 1992); Helleiner, *States and the Reemergence of Global Finance*, pp. 15-16.

¹⁰¹ Poret, "The Experience of the OECD with the Code of Liberalization of Capital Movements," pp. 3-4.

Of the EU, political scientist Kathleen McNamara writes, “A neoliberal policy consensus that elevated the pursuit of low inflation over growth or employment took hold among political elites” throughout Europe. Capital controls, moreover, “run directly counter to the ideology of neoliberalism.”¹⁰² Neoliberalism altered fundamentally how policy makers understood their options, primarily by offering a ready and coherent alternative paradigm to the perceived failure of the Keynesian model. Neoliberal ideas influenced policy makers throughout the developed and developing worlds.¹⁰³

But neoliberalism is insufficient as an explanation for the evolution of the rules about capital in international organizations. It would deprive the word of all meaning to insist that France’s Socialist Party, Delors, Chavranski, Camdessus, and the other authors of the liberal rules of global capital were “neoliberals,” and that the label offers sufficient insight into the choices they made. The formulation of these rules was driven neither by professional economists nor by policy makers trained in American economics, neoliberal or otherwise. There is more to the story of how the formal rules of globalization were written.

Enabling Capital and Obliging Governments

The trade-offs associated with liberating or regulating capital flows are, arguably, as difficult to manage as any in macroeconomic policy making. The decision to liberalize international capital flows must take account of potential benefits and risks.¹⁰⁴ Many of the benefits are straightforward. By liberalizing countries increase their access to foreign private capital. Capital mobility facilitates an efficient global allocation of savings, thereby fostering economic growth and welfare around the world. Residents are offered the opportunity to earn higher risk-adjusted returns on their savings. A country’s financial sector may increase its competitiveness, as well as attractiveness to investors. Many economists and policy makers argue, finally, that financial markets impose a useful discipline on macroeconomic policy making.

The risks of liberalization have worried policy makers for more than a century. Financial markets are more susceptible than goods markets to crises because of asymmetric or imperfect information that might elicit herd behavior among market participants. Moreover, being subject to wide swings in market sentiment unrelated to

¹⁰² McNamara, *The Currency of Ideas*, pp. 3 and 52.

¹⁰³ On their role in emerging markets see Jeffrey M. Chwieroth, “Neoliberalism’s Role in Capital Account Liberalization in Emerging Markets,” Paper presented at the Annual Meeting of the American Political Science Association, Boston, Mass., August 29-September 1, 2002.

¹⁰⁴ These potential benefits and risks are reviewed in Rawi Abdelal and Laura Alfaro, *Capital Controls*, Harvard Business School Note 702-082 (2002), pp. 3-6. For a recent comprehensive review see Richard N. Cooper, “Should Capital Controls Be Banished?” *Brookings Papers on Economic Activity*, no. 1 (1999), pp. 89-141.

market fundamentals leaves financial markets susceptible to crises that take the form of self-fulfilling prophecies on the part of market participants.¹⁰⁵ Liberalization thus increases the risk that a country will experience a financial crisis and makes a country more vulnerable to contagion from the other countries' crises. Excessive inflows of capital can distort domestic asset prices and thereby introduce inefficiencies. Domestic financial sectors, if they lack the appropriate institutional framework, may be weakened rather than strengthened. Finally, liberalization's most worrisome result from the government's point of view is the attendant obligation to submit to financial market discipline. In other words, a government that liberalizes capital flows reduces the policy options available to it, particularly if the exchange rate is fixed.

Economists and political scientists have generated a sophisticated scholarly debate on the balance between the benefits and risks of capital liberalization that continues today and is unlikely ever to reach a definitive resolution. One critical question for this book is: Was the policy consensus that favored liberalization – the consensus that provided the intellectual justification for new rules in the EC, OECD, and IMF – based on the evidence produced by scholars that the benefits exceeded the risks? One possible explanation, in other words, for new rules to liberate capital is that such rules simply make good economic sense. Perhaps scientific knowledge determined these international politics.¹⁰⁶

The short answer to this question is: No. Scientific knowledge did not create the consensus. The conventional wisdom of the 1980s and early 1990s did not emerge from the accumulation of evidence that capital liberalization promotes economic growth, or that the benefits of liberalization systematically outweigh its risks. Such evidence did not exist then, nor does it exist now.¹⁰⁷ The evidence generated by scores of econometric

¹⁰⁵ Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*, rev. ed. (New York: Basic Books, 1989). John Maynard Keynes offered the classic "beauty contest" metaphor; see Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace Jovanovich, [1936] 1953), pp. 155-156.

¹⁰⁶ If scientific knowledge were the basis for this rethinking of the rules of the international monetary system, then the group of policy makers who proposed, authored, and advocated new liberal rules might be likened to an "epistemic community." See Peter M. Haas, ed., *Knowledge, Power, and International Policy Coordination* (Columbia, S.C.: University of South Carolina Press, 1997).

¹⁰⁷ This case was made forcefully in Bhagwati, "The Capital Myth." Also see Dani Rodrik, "Who Needs Capital Account Convertibility?" in *Should the IMF Pursue Capital-Account Convertibility?*; Rodrik, "How Far Will International Economic Integration Go?" *Journal of Economic Perspectives*, vol. 14, no. 1 (2000), pp. 177-186; and Joseph E. Stiglitz, "Capital Market Liberalization, Economic Growth, and Instability," *World Development*, vol. 28, no. 6 (2000), pp. 1075-1086. Compare, however, the positive results associated with the research program of Dennis P. Quinn: Quinn, "Correlates of Change in International Financial Regulation," *American Political Science Review*, vol. 91, no. 3 (1997), pp. 531-551; Quinn and Carla Inclán, "The Origins of

studies was mixed, even contradictory. The masterly historical synthesis produced by Maurice Obstfeld and Alan Taylor reports that no definitive conclusion can be reached: "Can the benefits and costs of global capital markets be neatly summarized and quantified? The historical record indicates the very contingent nature of any attempt to do so. Some countries have flourished upon financial opening, others have suffered disaster."¹⁰⁸ The economics profession had not reached an evidence-based, scientific consensus that policy makers adopted for a liberalizing agenda.

To the contrary, one of the arguments in favor of the IMF amendment made by then First Deputy Managing Director Stanley Fischer was that the *lack* of knowledge was a compelling reason for the Fund to take upon itself the task of building a more informed understanding of capital liberalization, an understanding to be achieved by gaining jurisdiction over capital and acquiring a mandate to promote liberalization. In the Fund, evidence did not drive the agenda; if anything, the lack of evidence lent a sense of urgency to create and institutionalize knowledge. "The difference between the analytic understanding of capital- and current-account liberalization is striking," argued Fischer in defense of the amendment. "The economics profession knows a great deal about current-account liberalization, its desirability, and effective ways of liberalizing. It knows far less about capital-account liberalization. It is time to bring order both to thinking and policy on the capital account."¹⁰⁹

Some years, and dozens of studies, later the evidence is still wanting.¹¹⁰ The last major study composed of cross-country regressions with indices of capital account openness that are widely perceived to be problematic has probably now been written by Kenneth Rogoff and his team in the IMF's Department of Research. Beginning with the theoretical models that elucidate the mechanisms that link capital account liberalization to economic growth, Rogoff and his team concluded: "A systematic examination of the evidence, however, suggests that it is difficult to establish a strong causal relationship.

Financial Openness: A Study of Current and Capital Account Liberalization," *American Journal of Political Science*, vol. 41, no. 3 (1997), pp. 771-813; and Quinn, "Capital Account Liberalization and Financial Globalization, 1890-1999: A Synoptic View," *International Journal of Finance and Economics*, vol. 8, no. 3 (2003), pp. 189-204.

¹⁰⁸ Obstfeld and Taylor, *Global Capital Markets*, p. 297.

¹⁰⁹ Stanley Fischer, "Capital Account Liberalization and the Role of the IMF," in *Should the IMF Pursue Capital-Account Convertibility?*, p. 8.

¹¹⁰ In fact, the research agenda has shifted away from cross-country growth regressions to more microeconomic studies of issues such as equity market liberalization and the cost of capital. See Peter Blair Henry, "Capital Account Liberalization, the Cost of Capital, and Economic Growth," *American Economic Review*, vol. 93, no. 2 (2003), pp. 91-96; Kristen J. Forbes, "One Cost of the Chilean Capital Controls: Increased Financial Constraints on Smaller Trade Firms," National Bureau of Economic Research working paper 9777, June 2003.

In other words, if financial integration has a positive effect on growth, there is as yet no clear and robust empirical proof that the effect is quantitatively significant.”¹¹¹

Rather than supporting the policy consensus, the econometric results of prominent, policy-oriented economists have begun to undermine an ambitious liberalizing agenda within international organizations. As Barry Eichengreen observes, “Given the breadth of support commanded by this synthesis, the lack of empirical substantiation of its fundamental tenets is worrisome indeed. If the evidence is really not there, then it is high time to rethink the conventional wisdom.”¹¹²

Another explanation for the rise of global capital holds that the end of the Bretton Woods fixed-exchange-rate system in the early 1970s undermined part of the rationale for capital controls: without an explicit obligation to maintain a specific exchange rate, governments could in principle liberalize capital flows without undermining their policy autonomy.¹¹³ In this view, capital’s freedom could be enabled without undermining the autonomy of governments. The end of system-wide fixed exchange rates encouraged governments to experiment with capital liberalization. In practice, however, exchange rate policy did not change dramatically. Recent reevaluations of the modern history of exchange rate management suggest that the early 1970s was not such a watershed. More than half of the exchange rate arrangements commonly understood to have been “managed floating” were *de facto* pegs, crawling pegs, or narrow bands.¹¹⁴ Perhaps more important, generalized floating as a phenomenon does little to explain the rise of obligations to liberalize capital in international organizations. Indeed, it was in Europe that the movement toward full capital mobility during the 1980s and early 1990s was most thorough; and it was in Europe that the first truly liberal rules for capital flows were written. Yet many European countries had begun to cooperate in exchange rate management immediately after the Bretton Woods system collapsed. European

¹¹¹ Eswar S. Prasad, Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, IMF Occasional Paper No. 220 (Washington, D.C.: International Monetary Fund, 2003), p. ix. Also see the coverage in “IMF Financial Globalization Study: Opening Up to Capital Flows? Be Prepared Before Plunging In,” *IMF Survey*, vol. 32, no. 9, May 19, 2003, pp. 137-141. See the coverage of the seminar discussion in “IMF Economic Forum: Is Financial Globalization Harmful for Developing Countries?” *IMF Survey*, vol. 32, no. 10, June 2, 2003, pp. 153-155.

¹¹² Barry Eichengreen, “Capital Account Liberalization,” p. 360. On the end of the consensus, since “shattered,” also see Jean Tirole, *Financial Crises, Liquidity, and the International Monetary System* (Princeton, N.J.: Princeton University Press, 2002).

¹¹³ For a version of this argument see Maurice Obstfeld, “The Global Capital Market: Benefactor or Menace?” *Journal of Economic Perspectives*, vol. 12, no. 4 (1998), pp. 9-30, at pp. 17-18.

¹¹⁴ See Guillermo A. Calvo and Carmen M. Reinhart, “Fear of Floating,” *Quarterly Journal of Economics*, vol. 117, no. 2 (2002), pp. 379-408; and Carmen M. Reinhart and Kenneth S. Rogoff, “The Modern History of Exchange Rate Arrangements: A Reinterpretation,” *Quarterly Journal of Economics*, vol. 119, no. 1 (2004), pp. 1-48.

countries fixed their currencies' values to one another first in the so-called Snake, then in the EMS, culminating in monetary union. Certainly the Europeans did not liberate capital because they had given up on fixed exchange rates.

Finally, policy makers frequently observe that capital was liberalized simply because capital controls had become too porous. Capital controls, as is so often said, "do not work" to constrain ever more mobile capital.¹¹⁵ To be sure, over time three important changes in the world economy undermined the effectiveness of controls. At the end of the war in 1945 most countries maintained trade as well as capital restrictions. The return to convertibility for trade transactions at the end of the 1950s afforded opportunities to evade capital account restrictions by, for example, over-invoicing imports or under-invoicing exports.¹¹⁶ Scholars have also argued that technological change and financial innovation altered the costs and benefits of capital controls. Capital controls, Eichengreen reports, "may have become less attractive because information and communications technologies have grown more sophisticated, rendering controls more porous and their effective application more distortionary."¹¹⁷ Financial market innovation, in derivatives in particular, made capital controls easier to circumvent. Additionally, once many countries had liberalized capital flows, it became increasingly difficult for any individual country to regulate capital unilaterally. Closely related to a decreasing ability to restrict outflows of capital was an increasing need to attract investors: governments seeking to attract increasingly mobile capital were obliged, according to this argument, to liberalize so as not to lose out to other more liberal, and presumably more attractive, locations for portfolio investment.¹¹⁸

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, each of which compounded the effects of the preceding. But trends that enable capital mobility are not the same as, nor do they inexorably lead to, rules that oblige governments further to

¹¹⁵ For a recent outline of the low and declining effectiveness of capital controls see Sebastian Edwards, "How Effective Are Capital Controls?" *Journal of Economic Perspectives*, vol. 13, no. 4 (1999), pp. 65-84. On the controversy over whether the Malaysian capital controls "worked," see Abdelal and Alfaro, "Capital and Control."

¹¹⁶ Eichengreen, *Globalizing Capital*, p. 94.

¹¹⁷ Eichengreen, "Capital Account Liberalization," p. 350. The strongest form of this argument can be found in Ralph Bryant, *International Financial Intermediation* (Washington, D.C.: Brookings Institution, 1987); Richard B. McKenzie and Dwight R. Lee, *Quicksilver Capital: How the Rapid Movement of Wealth Has Changed the World* (New York: Free Press, 1991); and Richard O'Brien, *Global Financial Integration: The End of Geography* (London: Pinter, 1992).

¹¹⁸ See Philip G. Cerny, "The Little Big Bang in Paris: Financial Deregulation in a Dirigiste System," *European Journal of Political Research*, vol. 17, no. 2 (1989), pp. 169-192; Cerny, ed., *Finance and World Politics* (Brookfield, Vt.: Edward Elgar, 1993); Goodman and Pauly, "The Obsolescence of Capital Controls?"; and Helleiner, *States and the Reemergence of Global Finance*, pp. 12-13.

liberalize capital. As the three episodes of French policy makers engaged in the writing of liberal rules for international organizations reveal, an important motivation of the French Left was to counteract the distributional consequences of ineffective capital controls. The diminishing effectiveness of capital controls thus became politically salient, though not for the reasons that many economists and policy makers assumed had driven the creation of a more liberal international monetary system. More importantly, none of these arguments helps to explain how newly liberal rules reinforced the trend toward capital mobility and obliged governments not to reverse course. The sources and effects of the rules of capital require further explanation.

An Institutional Perspective: How the Formal and Informal Rules Matter

The internationalization of finance was based on institutional foundations. Globalization as we know it could not have occurred without having been enabled by international institutions. International institutions consist of both formal, written and informal, unwritten rules. The formal rules of international institutions are often, though not always, interpreted and applied by the bureaucracies of international organizations. The informal rules of international institutions, in contrast, are social norms that emerge from the interactions among governments, firms, and international organizations.

International institutions, and the organizations associated with them, exert a number of distinct influences on governments and markets.¹¹⁹ Institutions and organizations regulate and constrain behavior by monitoring the compliance of governments with their formal commitments, providing information about compliance to other governments, and proposing or introducing punishments and rewards. This conceptualization of the effects of institutions, with its origins in economics, focuses on how they reduce transaction costs.¹²⁰ The OECD's CMIT oversaw the Code of

¹¹⁹ On the regulative (rationalist) and constitutive (constructivist or sociological) effects of rules and 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. 5; 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 regulatory and constitutive power of international organizations see Michael Barnett and Martha Finnemore, *Rules for the World: International Organizations in Global Politics* (Ithaca, N.Y.: Cornell University Press, 2004), p. 7.

¹²⁰ Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton, N.J.: Princeton University Press, 1984). For more on the rationalist research agenda in the study of international institutions see Lisa L. Martin and Beth A. Simmons, "Theories and Empirical Studies of International Institutions," *International Organization*, vol. 52, no. 4 (1998), pp. 729-757. On institutionalist theory in economics see Douglass C. North, "Institutions," *Journal of Economic Perspectives*, vol. 5, no. 1 (1991), pp. 97-112; North, *Institutions*,

Liberalization; the European Commission ensured compliance first with the capital liberalization directive and then with the Maastricht treaty; and IMF staff undertook surveillance of members' macroeconomic policies. Meanwhile the credit rating firms Moody's and S&P, with increasing formality and quasi-public authority, monitored governments' policies, and their implications for sovereign risk, on behalf of financial markets and regulators alike.

Institutions and organizations also constitute state identities and define the boundaries of legitimate policies.¹²¹ The formal rules of organizations specify members' obligations, and the rules thereby define the policy practices that lead other members to recognize what constitutes appropriate behavior on the part of other governments. The rules of the OECD constitute the policy practices of "developed" states, just as the rules of the EU define the boundaries of legitimate policies enacted by "European" states. "Sociology's core insight," observes Frank Dobbin, "is that individuals behave according to scripts that are tied to social roles. Those scripts are called conventions at the collective level and cognitive schemas at the individual level."¹²² The codification of the norm of capital mobility in the OECD and EU changed the scripts for "developed" and "European" states: those two scripts articulate an obligation to permit capital to move freely, as well as an intellectual justification for such a policy.

The sociological approach to institutions emphasizes that they are, in the words of Iain Johnston, "social environments" composed of collective understandings, knowledge and information sharing, and learning among policy makers representing their governments.¹²³ The bureaucracies of international organizations contribute to the

Institutional Change, and Economic Performance (Cambridge: Cambridge University Press, 1990); and Avner Greif, "Historical and Comparative Institutional Analysis," *American Economic Review*, vol. 88, no. 2 (1998), pp. 80-84. North has, with colleague Arthur T. Denzau, moved in the direction of a more sociological approach to institutions by focusing on mental models that are "shared intersubjectively." See their "Shared Mental Models: Ideologies and Institutions," *Kyklos*, vol. 47, no. 1 (1994), pp. 3-31.

¹²¹ This means that they also may delegitimize policy practices. See Rodney Bruce Hall, "The Discursive Demolition of the Asian Development Model," *International Studies Quarterly*, vol. 47, no. 1 (2003), pp. 71-99.

¹²² Frank Dobbin, "The Sociological View of the Economy," in *The New Economic Sociology*, ed. Dobbin (Princeton, N.J.: Princeton University Press, 2004), p. 4.

¹²³ Alastair Iain Johnston, "Treating Institutions as Social Environments," *International Studies Quarterly*, vol. 45, no. 4 (2001), pp. 487-515. On sociological institutionalism see, for example, James G. March and Johan P. Olsen, *Rediscovering Institutions: The Organizational Basis of Politics* (New York: Free Press, 1989); Walter W. Powell and Paul J. DiMaggio, eds. *The New Institutionalism in Organizational Analysis* (Chicago: University of Chicago Press, 1991); Martha Finnemore, "Norms, Culture, and World Politics: Insights from Sociology's Institutionalism," *International Organization*, vol. 50, no. 2 (1996), pp. 325-347; and Finnemore, *National Interests in International Society* (Ithaca, N.Y.: Cornell University Press, 1996). An extraordinarily insightful

“development of consensual knowledge” among member governments.¹²⁴ Moreover, interactions among government representatives in international organizations lead them to encourage, cajole, and convince. Above all, policy makers in international organizations talk to and argue with one another.¹²⁵ Based entirely on a process of peer review and peer pressure, the OECD, more than most organizations, is designed to benefit members by providing them a forum in which they can discuss and learn from one another’s experiences. The EU and IMF being more bureaucratized, most conversations about policy occur not among members but between organization staff and policy makers within member governments. All three organizations nevertheless define and promote norms and rules.¹²⁶

These international organizations have been eager teachers of their norms and rules, and during the 1990s the OECD and EU had some eager pupils among the countries seeking to join their organizations. The real and symbolic benefits of membership in the OECD and EU encouraged prospective members to embrace each organization’s rules, including capital liberalization, often without questioning the content of the constitutive rule that would ensure their recognition as “developed” and “European.” A Czech central bank official recalls that central and east European governments competed during the early 1990s to determine “who was the best pupil of the developed market economies.”¹²⁷ The view from Brussels was similar: one Commission negotiator recalls in acceding countries an “eagerness to be perceived as right up to European standards for openness to capital movements.”¹²⁸ The countries that joined the OECD and EU readily embraced the script of capital liberalization.¹²⁹

review can be found in James Johnson, “How Conceptual Problems Migrate: Rational Choice, Interpretation, and the Hazards of Pluralism,” *Annual Review of Political Science*, vol. 5 (2002), pp. 223-248, esp. p. 232.

¹²⁴ Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Cambridge, Mass.: Harvard University Press, 1994), pp. 12-13.

¹²⁵ See Thomas Risse, “‘Let’s Argue!’: Communicative Action in World Politics,” *International Organization*, vol. 54, no. 1 (2000), pp. 1-39.

¹²⁶ Barnett and Finnemore, *Rules for the World*, p. 31. Also see Martha Finnemore, “International Organizations as Teachers of Norms,” *International Organization*, vol. 47, no. 4 (1993), pp. 565-597; and Wade Jacoby, “Tutors and Pupils: International Organizations, Central European Elites, and Western Models,” *Governance*, vol. 14, no. 2 (2001), pp. 169-200.

¹²⁷ Author’s interview with Oldřich Dědek, Vice Governor, Czech National Bank, Prague, March 24, 2004.

¹²⁸ Author’s interview with Stephane Ouaki, Negotiator, DG Enlargement, European Commission, Brussels, November 3, 2004.

¹²⁹ On imitation as a mechanism for the influence of a script see Stephen Krasner, *Sovereignty: Organized Hypocrisy* (Princeton, N.J.: Princeton University Press, 1999), p. 64. For an argument about the influence of persuasion when the source of authority is part of the group that the object of persuasion is eager to join see Jeffrey T. Checkel, “Why Comply? Social Learning and European Identity Change,” *International Organization*, vol. 55, no. 3 (2001), pp. 553-588.

Although the CMIT and European Commission were enthusiastic proponents of the script, neither forced prospective members to accept these rules. And for all of the enthusiasm of IMF management for capital liberalization, the Fund never had the legal tools systematically to coerce members to embrace liberalization when their governments were not keen to follow Fund advice. As John Ikenberry and Charles Kupchan argue, socialization is most commonly effected through a combination of purposeful behavior by powerful governments or organizations and domestic conditions in less powerful states that make policy makers more receptive to a new script.¹³⁰

These constitutive effects of institutions and organizations on governments' financial regulations are similar to the arguments scholars use to explain the diffusion of policy practices around the world.¹³¹ The scholarly literature on diffusion has not, however, explored the influence of international organizations on the spread of policy practices. Eichengreen observes that countries are more likely to liberalize capital flows "when members of their peer group have done so."¹³² Similarly, Simmons and Elkins explore the possibility that the intellectual justification for liberalization may be spread through communication within or learning from cultural reference groups.¹³³ Although these studies do not include OECD or EU membership in their operationalization of peer or reference groups, in the chapters that follow I trace the influence of those two organizations on capital liberalization specifically. The OECD and EU are indeed the most influential reference groups in international financial markets.

Conceiving international organizations as bureaucracies enables analysis of the influence of the bureaucrats themselves on the evolution of the formal and informal rules of globalization. In the OECD, EU, and IMF the managers of the organizations expressed strong preferences about their respective mandates. The IMF's management appeared to adopt its new mandate – capital liberalization – informally, because these

¹³⁰ G. John Ikenberry and Charles A. Kupchan, "Socialization and Hegemonic Power," *International Organization*, vol. 44, no. 3 (1999), pp. 283-315.

¹³¹ Beth Simmons, Frank Dobbin, and Geoffrey Garrett, "The International Diffusion of Liberalism," unpublished ms., June 2004. See also Simone Polillo and Mauro F. Guillén, "Globalization Pressures and the State: The Worldwide Spread of Central Bank Independence," *American Journal of Sociology* (forthcoming); and 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. An early and insightful analysis of the diffusion of an economic policy practice can be found in Stephen J. Kobrin, "Diffusion as an Explanation of Oil Nationalization," *Journal of Conflict Resolution*, vol. 29, no. 1 (1985), pp. 3-32. On coercive, normative, and mimetic isomorphism see Dobbin, "The Sociological View of the Economy," pp. 13-14.

¹³² Eichengreen, "Capital Account Liberalization," p. 350; and Simmons and Elkins, "The Globalization of Liberalization."

¹³³ Simmons and Elkins, "The Globalization of Liberalization," pp. 175-176.

policy makers believed in that goal. This informal mandate issued from the self-identified expertise, not the legal basis, of the Fund's management.¹³⁴ Appropriation of a mandate on the basis of the bureaucracy's interpretation of the truth value of the arguments, as opposed to its legal authority, may be described either as, according to Pauly, "institutional adaptation," or, more critically, according to Barnett and Finnemore, an organizational pathology.¹³⁵

Even the interactions among the financial markets, the credit rating agencies, and sovereigns are irreducibly social. Two stylized facts are revealing: in 1958 capital controls did not signal heresy, or a lack of commitment to repaying sovereign debt; in 1998 capital controls apparently signaled poor international financial citizenship. The policy was the same, but the content of the signal – the inference that financial markets would draw – was different. The argument that capital controls could signal orthodoxy in 1958 and heresy in 1998 is central to the scholarly literature, but it is also deeply problematic. Scholars cannot analyze the social meanings, the inferences that audiences draw, without also analyzing social norms.¹³⁶ The very idea of a financial regulation as a signal requires that the expectations of the audience be studied as well. "Social meaning is a product of social norms," observes Cass Sunstein, and that is how one arrives at an informed understanding of the practices that "conduct signals."¹³⁷ Economic practices can have no social meaning – that is, they can convey no signals – in the absence of a social context that sets standards and expectations. When the social context changes, so do the inferences that markets draw from policies.

The Rest of the Argument in Brief

In the pages that follow I explain the evolution and influence of the European Community's directives on capital liberalization (chapter 2), the OECD's Code of Liberalization (chapter 3), and the IMF's Articles of Agreement (chapter 4). The formal and informal rules of these three international organizations are critical pieces of the international financial architecture. These organizations were influential in promoting capital liberalization among existing members. Europe's formal rules in favor of liberalization followed the decisions of many Community (then Union) members to

¹³⁴ A similar story is told in Barnett and Finnemore, *Rules for the World*, ch. 3.

¹³⁵ See Louis W. Pauly, "Good Governance and Bad Policy: The Perils of International Organizational Overextension," *Review of International Political Economy*, vol. 6, no. 4 (1999), pp. 401-424; and Michael N. Barnett and Martha Finnemore, "The Politics, Power, and Pathologies of International Organizations," *International Organization*, vol. 53, no. 4 (1999), pp. 699-732.

¹³⁶ Max Weber, *Economy and Society*, ed. Guenther Roth and Claus Wittich (Berkeley: University of California Press, 1978), pp. 4-5.

¹³⁷ Cass R. Sunstein, "Social Norms and Social Roles," *Columbia Law Review*, vol. 96, no. 4 (1996), pp. 903-968, at p. 925.

liberalize. Still, Italy, along with Greece, Ireland, Portugal, and Spain, were obliged to liberalize more quickly than their governments and societies would have chosen without the emergence of a new liberalizing agenda in Brussels. In the OECD peer pressure always pushed in the direction of liberalization but was almost never decisive in any member country's decision to liberalize further. The OECD's subtle, but persistent influence was manifested in the redefinition of the economic policy norms of developed countries. The IMF's influence on capital liberalization among members was the least consistent of the three, and only the failed promise of a new formal mandate and jurisdiction over the capital account would have enabled the Fund's liberalizers. The most unambiguous and decisive influence of these organizations was felt when the OECD and EU expanded their membership after the new liberal rules were in place.

The changes in the formal and informal rules of the EU, OECD, and IMF produced another important, but widely underappreciated effect on globalization: as practices and codes became more liberal, so, too, did the conventional wisdom within the international financial community. To put the argument most evocatively, these organizations shifted the orthodoxy away from capital controls and toward capital freedom. The content of this orthodoxy matters in part because the rating agencies' interpretations thereof necessarily inform their opinions on the creditworthiness of sovereigns. I consequently also describe the evolution of the beliefs and influence of the rating agencies (chapter 5). The sustainability of unorthodox economic policies is a function, first, of what the agencies consider to be appropriate and effective and, second, what the agencies' analysts believe the financial markets consider to be appropriate and effective. Moody's and S&P's analysts who might believe in a more unorthodox approach are nevertheless constrained by the beliefs of the markets, the reactions of which make and break government programs.¹³⁸ Although S&P has tended to be more orthodox than Moody's with respect to capital liberalization, neither could attempt to evaluate policies without some representation of their own and the markets' beliefs.

In the conclusion (chapter 6) I describe the informal rules of the international monetary system at the beginning of the twenty-first century, in the wake of the financial crises that wreaked havoc on emerging markets around the world between 1997 and 1998. The formal rules of the EU, OECD, and IMF have not changed since the crisis erupted in Thailand in the middle of 1997 or culminated in Russia toward the end of 1998, but the informal practices of the bureaucracies of these organizations have changed a great deal. These bureaucracies have been part of a general rethinking within the international financial community of the risks and benefits of capital liberalization. Skeptics of liberalization have felt empowered, if not simply proven right. More consequentially, many policy makers who had subscribed to the emerging consensus in

¹³⁸ See Grabel, "Creating 'Credible' Economic Policy"; and Jonathan Kirshner, "The Study of Money," *World Politics*, vol. 52, no. 3 (2000), pp. 407-436, at p. 423.

favor of liberalization admit to rethinking the balance of risks and benefits.¹³⁹ The process of interpreting crises, and of gleaning their lessons, will continue indefinitely. The facts of the crises cannot convey their own lessons, and the process of creating consensual interpretations is inherently political.¹⁴⁰ After the crises of the 1930s, the emergent consensus propagated by Nurkse, Keynes, and others privileged government regulation at the expense of capital's freedom. Over time, however, some economists and policy makers began to argue that the illiberalism of the post-war years was an over-reaction to memories of financial devastation that were all too fresh. Milton Friedman, for example, argued that economists and policy makers had learned the wrong lessons from the crises.¹⁴¹ Either the international financial community forgot the lessons of the interwar years, or the dispassionate analysis of later generations produced a more balanced assessment of risks and benefits. The pattern seems, in either case, to recur.

Where Ricardo and Marx were as one, neither the nineteenth nor the twentieth century knew doubt about the freedom of international capital. In the new century doubt was reborn. Even as the IMF and its major shareholders abandoned the capital account amendment, IMF staff became reluctant even to discuss capital liberalization in the organization's surveillance or technical assistance activities. Negotiations related to Slovakia's accession to the OECD in 2000 revealed considerable softening of the OECD's and U.S. Treasury's positions on capital liberalization; or one might argue that they had

¹³⁹ 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); Morris Goldstein, *The Asian Financial Crisis: Causes, Cures, and Systemic Implications* (Washington, D.C.: Institute for International Economics, 1998); Wade and Veneroso, "The Gathering World Slump and the Battle Over Capital Controls"; Wade, "The Fight Over Capital Flows"; Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton, 2002); and Jacqueline Best, "From the Top-Down: The New Financial Architecture and the Re-embedding of Global Finance," *New Political Economy*, vol. 8, no. 3 (2003), pp. 363-384. On the crisis in general see especially Wing Thye Woo, Jeffrey D. Sachs, and Klaus Schwab, *The Asian Financial Crisis* (Cambridge, Mass.: MIT Press, 2000); and T. J. Pempel, ed., *The Politics of the Asian Economic Crisis* (Ithaca, N.Y.: Cornell University Press, 1999).

¹⁴⁰ Blyth, *Great Transformations*; Wesley W. Widmaier, "Constructing Monetary Crises: New Keynesian Understandings and Monetary Cooperation in the 1990s," *Review of International Studies*, vol. 29, no. 1 (2003), pp. 61-77; Widmaier, "Keynesianism as a Constructivist Theory of the International Political Economy," *Millennium*, vol. 32, no. 1 (2003), pp. 87-107; and Widmaier, "The Social Construction of the 'Impossible Trinity': The Intersubjective Bases of Monetary Cooperation," *International Studies Quarterly*, vol. 48, no. 2 (2004), pp. 433-453.

¹⁴¹ Milton Friedman, "The Case for Flexible Exchange Rates," in his *Essays in Positive Economics*, (Chicago: University of Chicago Press, 1953), pp. 176-177. Also see Helleiner, *States and the Reemergence of Global Finance*, p. 117.

hardened in the other direction: liberalization was to be undertaken gradually and only with the proper institutions and prudential regulations in place. When Slovak negotiators outlined an ambitious plan for rapid capital liberalization the CMIT, at the insistence of the U.S. Treasury, slowed the accession process, encouraged caution on the part of Slovak authorities, and required, for the first time in the history of OECD accessions, a formal review of the health and governance of the country's financial sector. Elena Kohútiková of the Slovak central bank considered the shift in priorities of the international financial community to have been quite profound: "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 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.'"¹⁴² The informal rules of the international monetary system had changed again as OECD and IMF policy makers reinterpreted their goals and mandates.

The orthodoxy of capital's freedom seems to have been undermined everywhere except for Brussels, in part because the codified norm of capital liberalization for European states is literally not open to interpretation. 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. Unrestricted capital mobility is part of the *acquis*, the accomplishments, of the community. Observes Stephane Ouaki, who negotiated the freedom of capital movements on behalf of the Commission for the 2004 accessions: "Once an obligation is on the books the Commission, well-oiled machine that it is, is responsible for enforcing the obligation. It is not the Commission's responsibility, nor its right, to interpret with any flexibility the *acquis*. And on capital movements the *acquis* is now unambiguous."¹⁴³

The difference between the IMF and EU came into sharpest relief during the European accession negotiations of Croatia and Romania during 2004 and 2005.¹⁴⁴ The Commission insisted, as it is obliged to do, that membership in the EU requires the complete liberalization of capital movements. At the same time IMF staff in Washington and on missions in Croatia and Romania contradicted the Commission's

¹⁴² Author's interview with Elena Kohútiková, Deputy Governor, National Bank of Slovakia, Bratislava, October 27, 2004.

¹⁴³ Author's interview with Stephane Ouaki, Negotiator, DG Enlargement, European Commission, Brussels, November 3, 2004.

¹⁴⁴ Bulgaria, the other east European candidate for membership, had by that time already liberalized its capital account.

recommendations and urged policy makers to delay their plans for capital liberalization. Officials in the national banks and finance ministries expressed their frustration at the competing, but equally insistent views emanating from Washington and Brussels. The international financial community is faced with, instead of consensus, what John Ruggie describes as “epistemic disarray.”¹⁴⁵ The voice of caution is in Washington. Capital mobility is still a European and developed-country norm; it is not the global norm.¹⁴⁶ The EU is the last bastion of unmitigated liberalism in international finance, and the further its membership grows the more Brussels enables globalization.

The EU’s unique liberalism in the international financial architecture heightens the French paradox, for it was in Europe that the French part in writing liberal rules for capital was most decisive and successful. There are two senses in which “the French” have influenced the globalization of finance. First, official French policy on rule changes within these three organizations had a disproportionate, and in two cases, decisive effect on members’ debate about the codification of capital’s freedom. Second, these three French policy makers played singularly important roles in the formulation of the organizations’ agendas with regard to capital account liberalization. The French have thus played three roles in the internationalization of finance. Between 1961 and 1983 France obstructed internationalization. Between 1983 and 1988 the French permitted internationalization, coming even to welcome it. But in 1988, the French undertook a new international mission. French policy makers took a leading role in enabling globalization.

In part the French paradox can be explained by two straightforward observations: a modernizing and liberalizing minority of policy makers in the French Treasury and Banque de France won the day in Paris when the country fell into crisis during the 1980s, and when the victors left the government to exert their influence in the international organizations that govern globalization they generalized for the wider world the policies that they had chosen for France. “There was no plan, however, to liberalize capital in all international organizations,” reflects Delors. “It was not a conspiracy. Those of us in that modernizing minority shared a common doctrine, and when we were placed in the organizations we continued to promote our doctrine.”¹⁴⁷

¹⁴⁵ John Gerard Ruggie, “At Home Abroad, Abroad at Home: International Liberalization and Domestic Stability in the New World Economy,” in *The Globalization of Liberalism*, ed. Eivind Hovden and Edward Keene (New York: Palgrave, 2002), p. 117.

¹⁴⁶ On the relationship among norms that are, and are not, global, see Martha Finnemore and Kathryn Sikkink, “International Norm Dynamics and Political Change,” in *Exploration and Contestation in the Study of World Politics*, ed. Peter J. Katzenstein, Robert O. Keohane, and Stephen D. Krasner (Cambridge, Mass.: MIT Press, 1999), p. 251.

¹⁴⁷ Author’s interview with Delors.

There has, more fundamentally, also been a French approach to globalization, and although many scholars and policy makers appear not to have noticed it, the French have been articulating the strategy for some time. Hubert Védrine, one of France's most influential thinkers on international affairs, suggests: "France will share in the adventure of globalization, which will also be marked by France. Our entire foreign policy is built around this idea."¹⁴⁸ With regard to the international financial system, France has marked globalization by taking the lead in formulating and writing the rules. The French formulation of rules for capital liberalization was, critically, focused on exactly that: rules, and the organization that was supposed to follow. Lamy puts it thus: "In Europe, at that time, the French vision succeeded: it was liberalization combined with organization. The stories of the IMF and OECD are similar: these were attempts to liberalize and organize simultaneously."¹⁴⁹ These episodes also, Lamy suggests, reflect the broader "French foreign policy doctrine of seeking coherence in international organizations."¹⁵⁰

The kind of globalization that the French fear – uncontrolled, *ad hoc*, without rules – is precisely the globalization the United States has nurtured. "If there is no system," observes Lamy, "with rules that constrain all states, then we have a problem."¹⁵¹ Owing to the overwhelming dominance of the United States in international financial markets, neither Wall Street nor the U.S. Treasury has perceived any need to write rules that might ultimately constrain them as well. Most of what either the largest financial institutions or the Treasury secretary would like to accomplish requires only the resources of the United States, and not the EU, OECD, or IMF. Certainly, neither Wall Street nor the U.S. Treasury has evidenced a compelling need to have Delors, Chavranski, or Camdessus advocate liberalization on their behalf. Thus, the U.S. approach to *ad hoc* globalization, befitting a hyper-power with narrow economic ambitions, stands in marked contrast to the French approach to "managed globalization," a strategy befitting a middle power with global ambitions.

¹⁴⁸ Quoted in Hubert Védrine, with Dominique Moïsi, *France in an Age of Globalization*, trans. Philip H. Gordon (Washington, D.C.: Brookings, 2001), p. 45.

¹⁴⁹ Author's interview with Lamy.

¹⁵⁰ Author's interview with Lamy.

¹⁵¹ Author's interview with Lamy.