1 The political economy of the international monetary and financial systems

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The 2008 global financial crisis and the sovereign debt crises that ravaged the European Union between 2010 and 2013 have thrust the international monetary and financial systems to the center of global political economy. The international monetary and financial systems provide the infrastructure for the global economy. The international monetary system – a system for exchanging national currencies at low cost at relatively stable rates and a balance-of-payments adjustment process – makes international trade possible. The international financial system – a network of private and public financial institutions – intermediates transactions between savers and borrowers who reside in different countries. These transactions provide short-term credit for international trade and longer-term finance for cross-border investment. Derivatives markets enable participants in the global economy to manage risk arising from transacting in multiple jurisdictions with multiple national currencies. Without these essential structures, there would be very little international trade and even less cross-border investment.

In the decade prior to the 2008 global financial crisis, international political economy (IPE) pushed the study of global money, finance and financial crises onto the back burner as scholars focused on seemingly more pressing research programs. One post-crisis review of pre-crisis scholarship, for instance, noted that in the preceding decade the field’s top journals published only a handful of articles devoted to international finance (Cohen 2009, 437). The relative lack of interest in international money and finance among IPE scholars probably reflected the sharp decline in the incidence of banking and currency crises across the world between 2000 and 2008. Indeed, whereas 74 banking crises occurred between 1990 and 1998, only five such events happened between 1999 and 2006 (Laeven 2011). In the broader context of the ‘Great Moderation,’ it was not difficult to conclude that banking crises no longer posed a major challenge to the global economy. Indeed, banking and other financial crises were so rare that the International Monetary Fund (IMF) was forced to lay off staff because revenue generated from crisis management programs had dropped so sharply. The events of 2008 made it quite clear, however, that the political economy dynamics associated with the international monetary and financial systems have profoundly important consequences.

Although heightened interest in the politics of global money and finance may be a recent phenomenon, the fundamental dilemma that recent crises highlight is not. Simply stated, the dilemma concerns how to capture the benefits of global monetary and financial integration without suffering substantial costs. This core dilemma emerged sharply in the last quarter of the nineteenth century as states in Europe, the Americas, and Asia embraced the Gold Standard, and thereby established the first truly international monetary system (Meissner 2005). Although the gold standard era is viewed in hindsight as a period of relative monetary stability, the last years of the nineteenth century and the early
years of the twentieth were marked by repeated banking and currency crises (Eichengreen and Bordo 2003). Indeed, the world’s independent nations suffered more than 60 banking crises between 1880 and 1913, with some crises, such as the 1890s Baring Crisis, threatening to undermine global financial stability (Reinhart and Rogoff 2009). Banking and currency crises became even more frequent following World War I as governments attempted to restore the pre-war gold standard. This effort was brought to a close by the series of banking, currency, and debt crises that ushered in the Great Depression. Between 1929 and 1933 the global financial system collapsed. More than 40 countries suffered banking crises, most Latin American governments defaulted on their debt, and all but a very few states abandoned the gold standard and tightly limited currency convertibility. Unable to exchange currencies, attain trade credit, or finance current account deficits, world trade flows shrunk sharply.

Adherence to the gold standard fixed exchange rate system facilitated cross-border flows of finance capital but restricted the ability of national governments to address domestic economic weakness via monetary expansion. Following World War II, industrialized states instituted a more flexible fixed exchange rate system to facilitate trade, but the needs of democratic politics made monetary sovereignty a necessity as well. The resulting arrangement, which was negotiated at the 1944 Bretton Woods conference, structured the global economy for the first post-war generation. The Bretton Woods system was organized with the American dollar at its core. Other currencies were fixed in value to the dollar, and the dollar was valued at $35 per ounce of gold. In order to maintain these valuations governments strictly limited the mobility of capital across borders.

So more than 50 years would elapse before societies again became willing to open their national economies to relatively unfettered international capital flows. Through most of the early post-war era very few governments, including the United States (US), allowed capital to flow relatively freely in and out of the national economy. Most Western European governments, and practically every developing-country government, tightly limited capital flows until the last decade of the twentieth century. Some developing-country governments, such as China and India, continue to regulate the ability of private individuals to move financial capital freely in and out of the national financial system. Not surprisingly, the era of limited international capital mobility was also an era of relative financial stability. Tight controls on cross-border lending and strict domestic banking regulations limited the frequency of banking and currency crises throughout the early post-war period. Yet, as governments liberalized domestic financial systems and removed restrictions on cross-border capital flows, global financial interdependence re-emerged as a defining element of the global economy (Cohen 1996). Deepening financial interdependence has been accompanied by an increased frequency of banking and currency crises. And like the late nineteenth century, some of these crises have threatened global financial stability. Indeed, the list of crisis-struck countries is a veritable ‘Who’s Who’ list of emerging market and industrialized countries: Sweden 1991; Mexico and Japan 1994; Thailand, Indonesia, and South Korea 1997; Brazil and Russia 1998; Argentina 2000; Turkey 2001; the United States, the United Kingdom, Iceland, Ireland, and more than 20 others in 2008.

Though the media focus on banking and currency crises because they are spectacular dramas, these events are manifestations of the deeper dilemma that governments face and that sits at the center of the political economy of the international monetary system.
This dilemma involves striking the appropriate balance between the benefits and the costs of international financial interdependence. The benefits of international financial interdependence accrue as national economies with relatively small pools of domestic savings gain the ability to borrow from the rest of the world in order to finance a higher level of investment and consumption. This enables a higher rate of investment and presumably a more rapid rate of per capita income growth than could be achieved independently. At the same time, high savings societies can earn higher returns by lending to countries where capital is relatively scarce than they can if able only to invest in the local economy.

The cost of financial interdependence takes the form of lost domestic economic autonomy. As financial interdependence deepens, national economic activity is increasingly shaped by foreign economic events. The so-called ‘unholy trinity’ is the classic expression of lost economic autonomy. The unholy trinity tells us that in a world of highly mobile capital, governments can use monetary policy to manage the domestic economy or to maintain a fixed exchange rate. They cannot simultaneously peg their exchange rate and set domestic interest rates independently for any sustained period. Because most governments remain reluctant to float their currencies freely, deepening financial interdependence has eroded monetary policy autonomy for most states. The amount of policy autonomy that states have lost varies substantially, however. At one end of the continuum lie states with permanently fixed exchange rates, such as members of the eurozone. These governments have no monetary policy that they could use to manage domestic conditions. The United States lies at the other end of the spectrum, for as a large economy that issues the world’s dominant reserve currency, the US has retained substantial monetary policy autonomy. Most countries fall between these two extremes: smaller and more financially open economies lie closer to the eurozone, while larger and less open economies enjoy greater autonomy.

National economies also lose autonomy in a broader sense as financial interdependence increases their exposure to financial shocks that originate beyond their borders. Global capital flows, for instance, can pour into an open economy and drive an investment boom. Such ‘capital flow bonanzas’ were important contributors to asset bubbles in East Asia in the 1990s and the ‘global savings glut’ contributed to the development of the asset bubbles that underlay the global crisis of 2008 (Reinhart and Reinhart 2009; Magud et al. 2012). ‘Sudden stops,’ episodes in which capital markets abruptly cease lending to a country, can push the affected economy into a deep crisis requiring IMF assistance. In addition, as domestic financial institutions become increasingly integrated with foreign financial institutions, they become increasingly exposed to foreign banking crises. The 2008 crisis, for instance, radiated outward from the US because of the exposure of European financial institutions to developments in the US investment financial system. Thus, in addition to constraining the ability to manage the domestic economy, financial interdependence increases the probability that domestic economic activity will be shaped by foreign financial shocks. Again, vulnerability to such shocks varies: larger economies are less affected by foreign shocks than small countries, and shocks that originate in countries on the periphery of the global financial system have less global impact than shocks that originate in financial centers.

Most government policy relevant to global finance thus strives to reap the maximum benefit from financial interdependence while minimizing the resulting loss of autonomy. International political economy strives to explain these government policy choices as
well as their domestic and global consequences. Research centers on a compact set of core questions. Are all governments equally constrained by global finance, and if not, why do some enjoy more autonomy than others? Given a set of governments that are similarly constrained, why do some embrace fixed exchange rates while others prefer to float? What drives financial crises, and why do some economies suffer banking and currency crises while others do not? How does politics shape the central characteristics of the IMF’s approach to crisis management? Why are international financial regulations underdeveloped relative to the apparent risk of crisis associated with global financial interdependence? And finally, how does change in the distribution of power in the international system change the structure of the global monetary and financial systems?

While political economists have explored these questions through a variety of perspectives, most research focuses on the interaction between system structure, the self-interest of private firms, the political institutions within which governments make policy, and the ideas that influence beliefs about appropriate policy responses. The chapters in this research *Handbook* explore how these factors have shaped the political economy of various facets of the monetary and financial systems. The *Handbook* is divided into four parts. Part I presents chapters that focus on the international system, exploring how the distribution of power in the system shapes its structure and dynamics. Part II presents a set of chapters that focus on the politics of exchange rate regime choice. Part III offers chapters that survey current research on financial crises and financial regulation. Part IV contains chapters that focus on international governance, including the IMF and institutional reform in the post-crisis eurozone.

Part I offers a set of chapters that explore how the distribution of power shapes system structure and dynamics. In Chapter 2, Andrew C. Sobel explores the origins and consequences of financial hegemony. He argues that some level of size as well as strong rule of law and property rights are necessary conditions but are insufficient to account for a state emerging as a liberal commercial and financial hegemon. Many nations are sufficiently large but do not acquire the capacity for liberal hegemony. Many nations develop sound rule of law and property rights and yet fail to develop an ability to provide important collective goods to support international cooperation during good times and bad. Some nations may be both large enough and enjoy the necessary institutions, yet fall short of being able to act as a liberal hegemony despite a desire to assume such a role. At the core of hegemonic leadership sit important mechanisms of public governance, public finance, and private finance. These mechanisms are essential to the emergence of a financial center in a society that is really a global financial center. This places that particular political economy at the heart of a global network and provides it with the tools to promote economic expansion not just at home, but globally. It also creates the capacity and tools to help manage economic downturns that could damage international relations, undermine the cooperation essential to productive globalization, and produce destructive policies that fuel rather than limit such downturns.

Hyoung-kyu Chey explores the factors that underpin the international use of national currencies in Chapter 3. This chapter reviews research on international currencies, with the aim of providing useful foundations to help develop a better analytical framework. It focuses particularly on three central concerns. First, it defines the concept of an international currency. Second, it examines the economic and the political costs and benefits of issuing an international currency. Third, it focuses on the structural and institutional
characteristics typically seen to play a large role in determining the international use of currency. The discussion encompasses not only the political economy literature but also the economics literature (including economic history), given the importance of the latter in the study of international currencies over the past decades and because much of the political economy research relies on its findings. This research in addition highlights a group of issues salient to the future political economy study of international currencies. Given that political economy research on international currencies is still in its early stages, there are in fact a number of significant issues awaiting further investigation.

Thomas Oatley examines the contemporary international dollar order in Chapter 4. This dollar standard has powerfully shaped international politics in the post-war era. At the most basic, the dollar’s central international role has enabled the US to extend power abroad – military as well as economic – at relatively low cost. Is this dollar standard now in decline? For many observers, contemporary developments in the global economy constitute a serious challenge to the dollar standard. The creation of the euro in 2000 confronted the dollar with a serious rival to its international role. China’s rapid ascent to the world’s second-largest economy and the Chinese government’s determination to internationalize the renminbi potentially constitute a second challenge to the dollar standard. The appearance of apparent challenges is accompanied by perceived weakness of the American economy. Sagging confidence in the dollar and the availability of alternatives may be sufficient to shift the system away from the dollar standard. The chapter highlights two theoretical perspectives that shape contemporary scholarship on the trajectory of the dollar standard. An instrumentalist perspective argues that the dollar will remain central as long as the dollar standard helps governments achieve central objectives. A geopolitics perspective argues that the fate of the dollar standard rests on America’s economic and military power. Though these perspectives differ in many ways, both tie the future of the dollar standard to the trajectory of US power. The chapter concludes by suggesting that these two perspectives provide a strong basis upon which future research can build. It suggests that two avenues for such research seem most important. First, more empirical research needs to be undertaken in order to evaluate these alternative perspectives. Second, the existing focus on secular decline could be supplemented by theoretical mechanisms that emphasize cyclical dynamics. Contemporary questions about the future of the dollar standard bear a remarkable similarity to questions posed in the early 1970s and again in the late 1980s. Yet, in each of these prior cases, the dollar standard recovered. Hence, more theory and more evidence are required before we can conclude that this time is likely to be different.

Herman Schwartz tackles global current account imbalances in Chapter 5. He asks two core questions: how did global financial and trade imbalances arise, and what are their implications? He argues that specific constellations of domestic power rather than ‘natural’ economic outcomes drove the sustained and substantial global imbalances of the 2000s. Put simply, the US dollar’s role as an international reserve currency interacts with politically generated weak domestic demand in China, Germany, and Japan to produce global and intra-European Union imbalances. Weak domestic demand in China, Germany, and Japan makes them reliant on exports for growth. These exports find their market in the United States, which is one of the few major economies that has a domestic political economy oriented towards consumption. But what then explains those US current account deficits and surpluses elsewhere? Here Schwartz argues that
in the current account surplus countries elites have shifted income out of the hands of ordinary households, dampening consumption. In the United States, domestic politics has similarly steadily shifted income towards the upper decile over the past two decades. Normally this would tend to dampen consumption there as well, but the United States is able to generate and sell assets to the rest of the world. This closes the loop with the dollar's status as international reserve currency. Export surplus countries are willing to accept US dollar denominated assets when they supply excess US consumption. The long-term sustainability of these imbalances thus rests on two factors: the ability of the US economy to generate and validate assets other countries are willing to hold, and political acquiescence to a world in which more and more wealth is controlled by a narrow set of elites in the United States and the three main exporters. By the same token, an unwinding of these imbalances requires shifts in the distribution of income that hurt those political elites. The chapter concludes that the real action around global imbalances and the monetary system occurs at the highest and lowest levels of the world economy, in the way that the US global empire binds together disparate domestic distributions of income. Imbalances are an outcome, a dependent variable, of these other processes.

In Chapter 6, W. Kindred Winecoff argues that monetary politics are linked to broader systems of development in the world economy. Because of this, the state of the monetary system is a vital element of the global production, trade, and investment economies. Control over a key currency confers a large degree of structural power, that can be understood in terms of prominence with a complex network, to determine what kinds of economic activity will be supported globally. Since World War II, the United States has been in possession of this influence. But there is a contradiction embedded within the dynamics of this system: as the US provides liquidity to the world economy, its external accounts weaken, and imbalances mount. This puts increasing pressure on private financial agents to successfully manage capital flows. If they do not – if the imbalances become too large to sustain or if US politics dictates a domestic monetary policy change – a crisis becomes likely. America’s monetary power gives it opportunities to force others into paying many of the costs of adjustment, but the domestic economy suffers in some respects as well.

Yale H. Ferguson offers a detailed examination of the political economy of the contemporary US–China exchange rate relationship in Chapter 7. He notes that current strain caused by the exchange rate issue is the third in a series of major extended dollar crises. The others were with Europe (late 1960s and early 1970s) and Japan (mid-1980s). In each case, the United States and its dominant currency have been challenged by rising (or resurgent) economic power elsewhere in the world. The first section of this chapter traces the rise and decline of the dollar–renminbi issue. It examines US–China trade patterns 1950–2010, a ‘Chimerica’ lull (2005–2009) when the US–China economic relationship looked almost like ‘a marriage made in heaven,’ the impact of the global financial crisis (2009 to early 2011) in escalating the currency issue, and the winding down of the dispute despite presidential candidate Romney’s attempt to revive it in the 2012 election. The chapter examines this conflict from the lens of the uncertainty about currency valuation, and the political factors that push the US government to pressure China and the factors in Chinese politics that cause China to resist American pressure.

Leslie Elliott Armijo and John Echeverri-Gent offer a Southern perspective on the structure of the global financial system in Chapter 8. They argue that the global financial
system is undergoing an uncertain transition. While the global financial crisis has called into question the efficacy and legitimacy of the institutions of global finance, a redistribution of financial resources is transforming the balance of power within the realm of international finance. They contend that in order to understand the trajectory of change, we must understand the perspectives of key strategic actors. They group these views into three mental models. Economic liberalism is the modal analytical framework for government and business circles in the United States and other wealthy democracies. Based on the premise that global markets provide efficient and socially optimal outcomes, it underscores the absolute gains they provide. Liberal institutionalism prevails in the academic community of the global ‘North.’ It emphasizes that international institutions and networks generate absolute gains by providing global public goods. Finally, economic realism is the dominant cognitive framework among government and academic circles throughout the global ‘South.’ It focuses on how the asymmetric control of strategic resources promotes relative gains that reproduce international inequalities. This chapter demonstrates how these mental models illuminate debates over three key issues in global finance: capital account liberalization, the international role of the US dollar, and the lessons of the 2008–2009 international financial crisis. Understanding their insights highlights the fact that the global market and financial institutions provide both absolute and relative gains. They also show how these mental models shape the strategies of key actors in the current transition. Dominant powers like the United States emphasize the absolute gains produced by markets and liberal institutions in order to minimize challenges to the status quo and the need to redistribute power. Emerging market countries highlight relative gains in their strategies to redistribute power while minimizing the disruption of absolute gains provided by global markets.

Part II focuses on the politics of exchange rate regime choice. In Chapter 9, Stefanie Walter argues that the interests of private actors, such as individuals, firms, and financial market participants, play an important role in policymakers’ exchange rate policy decisions. Private actors’ preferences about the exchange rate level arise from a joint consideration of consumption patterns, type of economic activity, financial situation, and the general aggregate effect of an exchange rate adjustment on the economy, rather than any of these factors on their own. Private actors’ preferences over exchange rate regime are strongly influenced by the importance they attribute to domestic monetary policy autonomy relative to the importance they attach to a stable exchange rate. Internationally oriented producers are more interested in exchange rate stability than domestically oriented producers. The preferences of financial market actors depend on their reliance on or investment in different types of capital (such as bank lending or portfolio investment). Individuals are affected by the exchange rate in a variety of ways – as workers, as financial market participants, as consumers, and as citizens – so that their preferences are often less clear-cut. Private actors’ preferences about the level and the stability of the exchange rate are related, and also depend on the trade-offs they pose for other economic policies. These trade-offs become particularly strong during economic crises, where private actor preferences can be shown to have a particularly strong influence on exchange rate and other macroeconomic policy decisions. The chapter concludes, therefore, by discussing how a focus on private actor preferences helps to explain some puzzling variation in exchange rate policy decisions during the recent global financial and economic crisis.
In Chapter 10, David H. Bearce surveys research that explores how domestic political institutions help to explain the public exchange rate commitments that governments make and the actual exchange rate outcomes they deliver. The chapter is divided into three major sections. The first section establishes and evaluates certain core theoretical assumptions underlying the research program on domestic political institutions and exchange rates. These assumptions include liberal institutionalism from international relations theory, optimal currency area theory, and the Mundell–Fleming framework from macroeconomics, and the relative importance of explaining exchange rate outcomes over exchange rate commitments. The second section reviews three waves of research. The first wave focused on de jure exchange rate regimes, the second on de facto regimes, and the third on explaining why governments often have a de facto regime that differs from their de jure regime. The third section then considers where these waves of research have found consensus, and identifies where additional research is needed to further our understanding of how domestic political institutions affect both exchange rate commitments and market outcomes. These considerations include why democracies often have different regimes than autocracies, how societal preferences in terms of the exchange rate regime are divided, and what are the underlying economic motivations in adopting particular exchange rate regimes. The chapter concludes with a brief discussion of how the recent financial crisis might reshape this research program.

In Chapter 11, Jana Grittersová surveys research on monetary and exchange rate policies in former command economies and highlights how this research has contributed to the broader literature on international monetary relations. She argues that the exchange rate regime choice in Eastern Europe is intriguing because in spite of their similar legacies of communism, governments in transition countries adopted rather diverse exchange rate regimes, ranging from free floats to currency boards, and they have experienced several regime shifts. These countries have also been part of two regional monetary ventures: some joined the European Monetary Union, while others were members of the failed ruble zone experiment. In addition to the theory on optimum currency areas – the central economic theory that informs our understanding of exchange rate regime determination in Eastern Europe – the chapter reviews various political economy explanations that revolve around four sets of factors that include the role of interest groups, credibility-related considerations and political institutions, ideas and identities, and international influences, including contagion of financial crises. One lesson of the post-communist transformation is that a fixed regime is more effective than a flexible one in the disinflation process. However, the existing empirical studies on transition economies are inconclusive with regards to the superiority of a particular exchange rate regime in terms of overall growth performance, confirming the general conclusions in the literature. The scholarship on exchange rates in transition has produced a number of insights that have challenged the existing literature and contributed to areas of interest for those studying international finance. First, the literature from the transition region has developed a more nuanced understanding of interest group politics, identifying alternative cleavages among interest groups and urging scholars to seriously consider bank and firm ownership when theorizing the preferences of societal groups in exchange rate policies. Second, scholars of transition offered dynamic models of monetary regimes based on strong micro-foundations. Third, research on post-communist transition has reinforced the importance of institutions in macroeconomic policies but also reminded us that more
research is needed to understand how historical legacies – colonial, pre-communist, communist – influence institutional building.

Scott Cooper explores the political economy of currency unions in the developing world in Chapter 12. There have been many attempts to create regional currency unions in the developing world since World War II, with all of the successful examples building on colonial currency institutions. There have also been widespread attempts at currency union through ‘dollarization.’ The most coherent theoretical explanation for all these institutions is the economic theory of optimum currency areas, which suggests that currency unions should be beneficial for many regions (or pairs of countries) that have high intra-regional trade and symmetric economic shocks. Political scientists have adopted this framework, and have given emphasis to interest group pressure driven by underlying economic interdependence. The problem is that the empirical pattern does not fit the theory well: economic analysis may suggest the proper cost–benefit trade-offs, but a broad range of factors motivates national leaders. Political theories of currency institutionalization emphasize path-dependence, power, governmental bargaining, and regional political ties, but theory-building in this area has been somewhat fragmentary so far and lacks sufficient empirical testing. To advance our understanding of currency unions, scholars will have to develop greater linkages between economic and political theories, between interest groups and government preferences, and between quantitative and qualitative methods. Scholars will also have to examine the diffusion of ideas, looking at how institution-building successes, and failures, influence efforts in other parts of the world.

In Chapter 13, Hongying Wang focuses on exchange rates in East Asia. The global financial crisis of 2007–2008 generated considerable interest in East Asian (including Northeast and Southeast Asian) exchange rates. Western pundits and politicians have blamed China and other East Asian economies for the global imbalances that led to the financial crisis, pointing their fingers at the region’s export-driven development model and large current account surpluses. Meanwhile, there has been much discussion of the lessons of the global financial crisis for the region, especially the benefits of regional cooperation to achieve some degree of insulation and protection from international financial turmoil. This chapter thus examines three related topics of East Asian exchange rates: (1) the evolution of exchange rate policies of the major countries in the region; (2) the development of regional financial and monetary cooperation; and (3) the implications of East Asian regionalism for global financial governance. Wang discusses the political sources and consequences of these monetary phenomena, drawing from a wide range of literature and pointing out ways in which future research can enhance our knowledge and understanding of these issues.

Part III contains a set of chapters that explore the political economy of crises – why they occur – and the political economy of financial regulation. Thomas B. Pepinsky offers a critical survey of the literature on international financial crises and their consequences for national politics in Chapter 14. Pepinsky focuses particular attention on national-level policy choices and political outcomes. After distinguishing conceptually among adjustment, reform, and political change as three broad families of political consequences to financial crises, he reviews three broad analytical approaches to the study of post-crisis political outcomes. Interest-based approaches center on the specific economic consequences of different kinds of financial crises, and look to policy outcomes as a consequence of the interaction between distributional pressures and national
political-economic profiles. Institutional approaches address the ways in which institutions mediate the articulation of interest group pressures. Ideational approaches emphasize the constitutive power of ideas in making sense of financial crises. The concluding section identifies several promising areas for future research, highlighting in particular the importance of the international context for conditioning the effects of international financial crises on domestic politics. It also highlights some general methodological problems with studying the highly complex economic and political consequences of financial crises.

In Chapter 15, Thomas D. Willett, Eric M.P. Chiu, and Stefanie Walter focus on the political economy of currency crises. The chapter begins with a brief review of the time inconsistency and commitment literature and emphasizes the need to distinguish between actual constraints on policymaking, which are relatively rare, and the effect of these discipline devices on policymakers’ incentives to implement time consistent policies. The chapter then discusses the effects of these sources of macroeconomic discipline in a number of frequently used economic models, most notably rational expectations and simple Mundell–Fleming (MF) and Phillips curve models. Since many open questions remain even in these models, the chapter also explores the implications of new views of the behavior of financial markets based on research on behavioral and neuro finance. These perspectives suggest that financial markets will often fail to provide early discipline as macroeconomic excesses emerge, but then provide strong disciplinary effects once crises break out. The final section offers an informal ‘model’ of imperfect market behavior in which financial markets at times fail to provide substantial discipline as financial excesses develop. But, once a crisis breaks out, financial markets wake up and begin to provide substantial discipline in ways that are more consistent with the assumption of rational expectations.

Kevin Young examines IPE scholarship on the politics of global financial regulation in Chapter 16. The focus is on the processes and actors involved in regulatory standards generated by transnational governance bodies, and the manifold ways in which this area has been subject to empirical investigation. He first argues that a central preoccupation of the IPE literature in this area is a fundamentally descriptive aim, with scholars trying to make sense of the basic structure and content of global financial regulation. Literature to date has focused on highlighting how transnational institutions operate to facilitate a governance role and more specifically how they exercise power over other actors, both state and non-state. The chapter then highlights four central themes that have animated research agendas of the last 20 years in this area. IPE scholarship has focused on the conditions for international regulatory cooperation to occur, the actual social process of regulatory policymaking itself, has analyzed the issue of a democratic deficit in transnational regulatory institutions, and finally, has explored the thorny issue of private sector influence in this area. The global financial crisis has been a boon to this literature, yet even basic empirical questions are yet to be adequately solved. Like in earlier work within this sub-field, recent research has been dominated not only by a debate about different explanatory theories and empirical research, but also more fundamentally by a ‘mapping’ exercise, trying to generate an adequate empirical description of what global financial regulatory governance is and how it works. The events of the global financial crisis and its aftermath have only exacerbated this kind of ontological concern within research, leaving many future opportunities for empirical questions to be explored.
In Chapter 17, W. Travis Selmier II presents a theoretical argument as to why, and how, financial products may migrate toward a club goods nature, differentiating between financial goods as units and ‘financial products’ as a set of those unit goods. Selmier employs a goods typology matrix developed by the Ostroms and refined by McNutt, and introduces the concept of ‘transmutation,’ in which actors employ technology and developments in theoretical finance to package financial goods into new financial products whose resultant property rights shift their good type in this typology matrix. Financial firms are active agents in this process through innovation, commonly called financial engineering. He then tracks the concurrent development, over the last half-century, of mortgage-backed securities and of financial ‘engineering’ – the application of advanced mathematical techniques to develop new financial products. Financial firms are self-designing organizations whose organizational fluidity and capacity to financially engineer not only permits, but also encourages and rewards the design and redesign of financial goods. Property rights structures may change as a result, shifting along either or both dimensions of the financial goods typology. Putting conceptual scaffolding on club goods from public choice and environmental economics gives us a new structural perspective on financial goods and empowers us with better governance ideas from these extensive literatures.

In Chapter 18, Philip G. Cerny develops a broad perspective for conceptualizing the regulatory challenges generated by global financial interdependence. He argues that capitalism has always depended on risk-taking by entrepreneurs to engender economic growth. However, this basic fact poses particular problems with regard to the financial system today. On the one hand, the financial sector, although usually thought to be characterized by ‘private goods,’ is in fact characterized by ‘club goods,’ which are essentially cartel-like – non-rivalrous but excludable. In a multi-nodal globalizing world, furthermore, especially one where economic growth is increasingly fueled by the exponential expansion and recycling of debt, there are many interconnected layers of finance – what is here called ‘differentiated cartelization’ – leading to inbuilt fragility. At the same time, the financial system as a whole is what has been called a ‘franchise good,’ in which the state and government regulation play a ‘constitutive’ role, paradoxically enabling financial institutions and market actors to operate in a relatively market-efficient manner; that is, providing public goods that enable the system itself to survive and, in theory, to undertake its fundamental function of reallocating capital efficiently from investors to borrowers. In this context, globalization, the ideology of deregulation, and the explosion of complex debt instruments from the 1980s to the 2000s together led to an excessive escalation of risk that caused the recent global financial crisis, and despite attempts at reregulation, key areas of regulatory reform are inadequate and manipulable by complex, cartelized financial sector groups. States are thus constrained by both globalized markets and transnationalized financial actors, as well as traditional domestic interest groups in the sector. Ultimately, the system is still vulnerable to excessive complexity, regulatory inadequacy, regulatory arbitrage, regulatory fatigue, manipulation by financial sector actors, the lack of state capacity to undertake effective macroprudential regulation, the fragmentation of global governance, and eventually, future crises.

Michael J. Lee continues the focus on financial regulation in Chapter 19. Embracing a broad macro perspective, Lee argues that governments face a trade-off between financial stability and the ability of capital to flow to profitable destinations at home and abroad.
Lax financial regulation allows capital to flow to innovative and profitable enterprises. While promoting growth, deregulation exposes institutions to riskier enterprises, amplifies linkages between firms and enables overextension by financial firms. Thus, finance-driven growth and innovation comes at a cost to financial stability. There has been considerable variance across time and space over where governments position their economies in this trade-off. This chapter contends that competition for global financial leadership is an important driver of this variation: when the leading financial power (that is, the country with the largest global stock exchange, the most foreign assets, and the global reserve currency) is ailing, it takes risks to deter a serious challenge. Financial deregulation offers a declining lead economy the ability to maintain the rents of leadership, but at the cost of greater risks. To assess the importance of positional motives behind financial deregulation, Lee conducts a macro-historical account of financial power and regulation since the late nineteenth century.

Part IV presents chapters that explore the core governance-related issues that lie at the center of the international monetary system. In Chapter 20, Richard W. Mansbach examines the international governance of global finance. The chapter focuses particular attention on the ways in which extensive global governance arrangements have emerged, as well as to those areas where such governance structures are underdeveloped and in some cases lacking entirely. It considers the evolving role of the IMF, the shift from the G7 to the G20, and the role of private sector organizations (such as the International Organization of Securities Commissions, IOSCO). It broadly considers two themes that have shaped this trajectory. The first such theme is the apparent erosion of state power and the rise of private sector governance. Here, one sees increased reliance on private sector self-regulatory network structures. The second theme is the rise of a set of emerging market countries – the so-called BRICS (Brazil, Russia, India, China, and South Africa). Here, Mansbach places emphasis on how their rising importance in the global economy has the potential to force a restructuring of existing institutional governance frameworks, a potential that we may be observing presently in the context of post-crisis IMF reforms.

Graham Bird and Dane Rowlands focus on the IMF in Chapter 21. They focus on the IMF’s bilateral relationship with member countries in the context of IMF (or IMF-supported) programs. They organize their chapter around the ‘life cycle’ of IMF programs. The chapter begins by providing some background information about IMF programs and aggregate IMF lending. They then look at the factors that influence participation in IMF programs and examine the extent to which the conditions that such programs embody are implemented. The chapter turns then to investigate the effects of programs not only across a range of macroeconomic variables, but also in terms of catalyzing private international capital markets and aid donors to lend. The chapter also briefly discusses what happens in the period that follows an IMF program, and examines whether countries graduate from the Fund or exhibit recidivist tendencies, returning to it to set up another program.

Chapter 22, by Bessma Momani and Kevin A. English, continues the focus on the IMF. In the absence of universally agreed-upon ‘rules of the game,’ the international monetary system relies inordinately on the IMF to exercise surveillance over its membership, in order to facilitate the smooth functioning of balance-of-payments adjustment and to supply the global public good of financial stability. The global financial crisis
highlighted the failure of the IMF to fulfill both these roles, but also the growing complexity of the governance and surveillance challenges facing the Fund in an increasingly interconnected global economy. Despite these glaring failures, there exists essentially no politically feasible alternative; and as such the Fund is now more central to international monetary relations than it has been at any other time in the post-Bretton Woods era. The heavy reliance of the Group of 20 on the Fund staff to support its Mutual Assessment Process is demonstrative of this new reality. International political economists have long been critical of IMF surveillance. The rich theory that IPE scholars have developed over the past decades is an important analytical tool for understanding both the failures of Fund surveillance and possible avenues for reform. This chapter provides an overview of the evolution and criticism of Fund surveillance since the end of the Bretton Woods era; the theory which IPE scholars have applied to developments in Fund surveillance; and recent reform efforts following the global financial crisis.

Attention shifts to institutional change in the European monetary arrangements in Chapter 23. Michele Chang argues that institutional change in the European Union (EU) has been driven by Germany’s regional hegemony. The process of economic and monetary integration in Europe began long before the start of European Economic and Monetary Union (EMU) in 1999. International exchange rate cooperation under the gold standard and Bretton Woods eventually gave way to European-level cooperation in the 1970s. Then as now, German ideas and interests have had a profound impact on the institutionalization of economic and monetary cooperation under the Snake, the European Monetary System (EMS), the original design of EMU and the reformed system of European economic governance that followed the sovereign debt crisis. The strong weight of Germany in terms of its large economy, its population, the widespread use of its currency, and the authority it derives from being a creditor country meant that German interests were decisive in European negotiations for monetary union. In particular the economic idea of monetarism and the German Bundesbank’s prioritization of price stability influenced Germany’s preferences during the periods of exchange rate cooperation (under the Snake and the EMS) as well as the institutionalization of EMU under the Maastricht Treaty. Finally, German financial interests preferred to keep German banking supervision at the national level rather than the European level. This resulted in an EMU characterized by the delegation of monetary policy to an independent central bank and relatively weak fiscal, financial, and economic policy cooperation as Germany hesitated to assume economic responsibility for its European partners.

In Chapter 24, Emmanuel Yujuico focuses on monetary organization in East Asia. He argues that in the post-war era, the United States, Japan, and China have taken turns attempting to shape the regional monetary organization of East Asia. Inevitably, their particular advocacies and strategies in this endeavor have evolved to reflect their relative fortunes. Whereas the United States once had no peer in this respect, the economic ascent of Japan and that of China later on have modified the trajectory of a still-nascent East Asian monetary architecture. Accordingly, this chapter provides an overview of major evolutions in this architecture through the conscious actions of its three main benefactors. First, the United States’ remarkably durable ‘San Francisco System’ is described, which inscribed the US firmly in the architecture despite it obviously being an extraregional power. Second, Japan’s efforts to address its economic interests within the usually friendly confines of this system are discussed. Third, China’s challenge to the ‘San
Francisco System’-based monetary architecture is addressed, especially its willingness to introduce an alternative system insofar as its political-economic interests diverge from the US–Japan alliance which has cast a long shadow over East Asia’s monetary relations. Lastly, an appraisal is offered concerning how East Asian monetary relations may evolve, with an emphasis on how security and other considerations impinge more on this region than others.

REFERENCES