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The International Politics of Harmonization:The Case of Capital Market Regulation

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The explosion of international financial activity over the last decade has been a central fact of international economic life. Balance of payments statistics indicate that cross-border transactions in bonds and equities for the G-7 rose from less that 10% of gross domestic product in those countries in 1980 to over 140% in 1995.[1] International bond and equity markets have reached staggering proportions: by the end of 1997, portfolio holdings of equity and long-term debt securities reached nearly $5.2 trillion[2]. Capital flows to developing countries and countries in transition grew from $57 billion in 1990 to over $286 billion in 1997 before plummeting to $148 billion in 1998.[3] Foreign exchange transactions reached an estimated average *daily* turnover of nearly $1.5 trillion in 1998 compared to $590 billion daily turnover in 1989.[4] The annual turnover in derivatives contracts - financial agreements that derive their value from the performance of other assets, interest or currency exchange rates, or indexes – was valued at $3.4 trillion in 1990.[5] In 1998 trading and derivatives activities of 71 of the world's leading banks and securities firms totaled more than $130 trillion.[6]

Global capital markets pose dilemmas for national financial regulators. On the one hand, financial liberalization and the removal of capital controls calls for the sophisticated "re-regulation" of capital markets.[7] Liberalization has increased competition in banking, which in turn has encouraged some firms to take on more risk. Innovative financial instruments and strategies and accounting and reporting standards that are difficult to compare across jurisdictions have compromised transparency. As capital controls have been lifted, the opportunity to use international markets for illicit activities has increased.[8] On the other hand, national regulatory authorities are finding it more difficult than ever to achieve their purposes unilaterally.[9] The speed with which international transactions take place, the complex structure of many financial contracts, and the multi-country network of branches and affiliates through which these transactions pass often makes it difficult for national authorities to properly supervise and regulate financial markets. Competitive concerns are also important. As in other areas of economic activity, national regulators typically want to avoid rules that raise costs for national firms or that encourage capital or financial activity to migrate to under-regulated jurisdictions.

Efforts to coordinate national policies to regulate specific aspects of international capital markets have cropped up repeatedly since the mid-1980s. They have varied in their degree of politicization and mode of institutionalization. This article provides a framework to explain such variation. It focuses on the *mechanisms* that encourage convergence across various sub-issue areas of financial regulation. Many of our traditional theories are not especially well suited to explaining this variance. Theories of "races to the bottom," for example, are of little help. They suggest that mobile capital will lead to competition in regulatory laxity across national jurisdictions, as governments vie for footloose capital, try to attract financial business, and attempt to grant competitive advantages to national firms. The predicted result is market-induced downward pressures on regulatory standards. It is difficult, however, to reconcile this simple competitive mechanism with the general *tightening* of regulatory standards in a number of areas. A capital adequacy requirement for banks provides one example.

Nor are prevalent theories of cooperation very useful in explaining the variance we see in the role and strength of international institutions in this area. If international institutions are created to reduce uncertainty and transactions costs,[10] it is surprising that they are much less developed in the regulation of financial markets than in trade. Volatility and volume of transactions should make financial regulation a good candidate for institutionalization, according to this argument. But cooperative arrangements to create common capital markets regulations are far less formal, comprehensive, and inclusive than those for trade.

Finally, contra arguments that underlie neo-liberal institutionalism, the international arrangements that have developed are not uniformly Pareto-superior to uncoordinated national policies. Some governments have resisted "harmonized" regulations precisely because they exact higher costs than they confer benefits within their jurisdiction. In some cases, harmonization has been coerced; in others it has taken place as the best available response to a changed regulatory environment over which smaller jurisdictions typically have little control. Theories that rest on joint gains will seriously mis-specify the mechanisms at work in these cases.

There are many aspects of international regulatory harmonization worthy of explanation. One could ask whether or not harmonization is likely at all, or ask whether harmonization is likely be "up" toward more rigorous standards, or "down" toward greater laxity. This article addresses these issues only indirectly. Its primary focus is on the *mechanisms* that account for the harmonization that we do observe across sub-issue areas of international finance. Just as we would like to know whether firms have arrived at similar prices for a good through collusion or through competition, it is important to distinguish *political* pressures to harmonize from *market* pressures to do so. The arguments developed here also inform a discussion about whether international institutions will play a roll in the process of harmonization, and if so, what that role will be. In short, the dependent variable of this study is primarily on harmonization *processes*.[11] This focus on process mechanisms provides a theoretical and practical understanding of the role of market incentives, political pressure, and multilateral institutions in the coordination of regulatory policies.

I propose a simple framework that focuses on strategic interactions between a dominant "regulatory innovator" and the rest of the financial world. Regulatory innovation in the dominant financial power is taken as exogenous. The dominant regulator does have to think strategically, however, about how foreign regulators react to its innovation. I argue that the two key explanations for how harmonization unfolds are (1) the incentives other regulators face to emulate or diverge from the regulatory innovation of the dominant financial power, and (2) the nature of the externalities produced by this reaction, as experienced in or anticipated by the dominant jurisdiction. These features help explain outcomes that vary across financial issue areas, specifically, whether harmonization will be economically or politically induced, as well as the role (if any) of international institutions in this process.

This model implies that most of the regulatory harmonization that has taken place in the 1980s and 1990s has not been "cooperative"; it has had much more to do with the unilateral imposition of decisions by the dominant financial center(s), than with mutual adjustment. The decisions of regulators in dominant financial centers can change the choice set for other countries drastically; they create a gestalt shift compared to which negotiations that follow may be little more than detailed hairsplitting. This does not mean that the United States, the United Kingdom, or even the G-10 always easily get their preferred regulatory outcome world-wide, for as I argue below, foreign regulators may have negative reaction functions that cause them to choose *divergent* regulatory trajectories. In these cases, harmonization is unlikely without political pressure from the dominant financial centers. Under certain conditions developed below, multilateral institutions are created to enhance political pressure.

The article is organized as follows. The first section outlines the basic argument of the paper. Section two provides evidence to show that in four issue areas illustrative of the variance in the two key explanatory variables – incentives to emulate and nature of externalities – the mechanisms of harmonization broadly accord with the expectations of the framework. The final section concludes.

I. Harmonizing International Capital Market Regulations: the Argument

The nature of international finance

Efforts over the past decade to coordinate the regulation of internationally active financial entities have been diverse and ad hoc. There is neither a single venue nor a unitary process for hammering out a regime for the regulation of international capital markets. No "World Capital Organization" parallels the World Trade Organization, nor have international rules been approached comprehensively, as was the case with the Law of the Seas during the 1970s. In fact, legally binding conventions for the international financial sector are rare (outside of Europe). Rule development has tended to involve small numbers of national regulators or supervisors, working briefly but intensively on relatively narrow issues, and producing nonbinding agreements. Arguably, the very nature of international finance has necessitated such an approach. Formal, protracted negotiations would be rapidly overtaken by technological change, financial innovation, and other market developments. Rapid changes in financial markets undercut the value of detailed, legally binding agreements that take time to ratify and implement legislatively. Overall, financial markets are swiftly moving targets whose supervision and regulation requires streamlined decision making and a tremendous amount of technical expertise.

Finance is distinct in another way as well: in few other issue areas is the dominance of one or two countries so profound. The United States and the United Kingdom dominate international financial issues by virtue of the size, efficiency, and internationalization of their markets as well as the sophistication of their regulatory structures. This in turn has to do with the special role of the dollar and sterling in international trade, as well as the extent to which firms from the United States and United Kingdom engage in trade and foreign direct investment. Some 85% per cent of world foreign exchange transactions involve the US dollar, a preeminence that does not yet seem to be challenged by the Euro. Moreover, firms headquartered in the United States and the United Kingdom accounted for 45% of total OECD foreign direct investment inflows and 38% of outflows in the 1990s.[12]

Finance is big business in both of these countries. The financial sector accounts for about 14 per cent of United States GDP, or to about 1.3 trillion dollars in 1998.[13] The private banking sector in the United States provided domestic credit equal to 162% of GDP in 1998. Only Switzerland's banking sector provided a higher ratio (177%) but for a much smaller GDP base (the average figure for high income countries was 140% of GDP).[14] Institutional investors mobilize more assets in the United States and the United Kingdom than anywhere else on the globe: In the United States, the ratio of these assets to GDP is 170 per cent, while in the United Kingdom the ratio is 162 per cent. These figures compare with 77, 75, and 46 percent for Japan, France, and Germany respectively.[15] A spate of bank mergers in the late 1990s left the United States with three of the six largest internationally active banks in the world by market capitalization.[16] More importantly, however, these are the prime centers in which foreign financial institutions conduct business. The biggest foreign banks in the world keep more assets in the United States and the United Kingdom than anywhere else.[17] London is the most highly internationalized financial center in the world, with over 550 international banks and 170 global securities houses in the city.

The United States and the United Kingdom are also heavyweights in the financial component of international trade. Together, these two countries exported on average during the 1990s $12.6 billion of financial services,[18] only slightly less than the total for the rest of the OECD combined. The United States was the second largest importer of financial services in the OECD as well (with average imports of $2.74 billion), second only to Italy (with $3.9 billion) and far ahead of third place Japan ($1.57 billion).[19] Banks from the United States and the United Kingdom are also at the center of the interbank payments system: together they account for nearly half of all intra-G-10 message flows between financial institutions for purposes of facilitating international payments.[20] As a result, regulators in the United States and the United Kingdom exercise jurisdiction over financial institutions and networks that are strategically important to the global financial system as a whole.

The dominance of these two countries' banking sectors is matched, and perhaps exceeded, by their dominance in equity markets. The world's largest stock markets are located in New York and London.[21] The American stock market alone accounts for nearly 50% of the world's stock market valuation.[22] The global market value of firms listed on the New York Stock Exchange (NYSE) and NASDAQ (the American over-the-counter equities market) in 1999 was $11.4 and $5.2 trillion respectively, while the corresponding figure for the London Stock Exchange is $3.0 trillion and Tokyo is $4.5 trillion.[23] U.S. stock markets raised $14.5 trillion dollars for firms in the United States over the course of the 1990s.[24]

Exchanges in the United States and London are highly internationalized and becoming even more so. The London Stock Exchange lists companies from 60 countries,[25] while the comparable figure for the New York Stock Exchange (NYSE) is 49. The number of foreign companies listed on the NYSE quadrupled between 1992 and 2000, for a current total of 400 firms.[26] Meanwhile, the volume of trade in non-U.S. shares on the New York Stock Exchange reached $687 billion in 1999.[27] The United States also dominates the $22 billion international market for depositary receipts,[28] accounting for three-quarters of the world total.[29] With the most active exchanges in the world, the North America accounts for nearly as much turnover in exchange-traded options and futures as do Europe and Asia combined.[30]

Finally, though difficult to quantify, much of the world's regulatory expertise with respect to finance is concentrated in the United States and United Kingdom. What come to be known globally as "best practices" with respect to supervision and regulation usually emanate from these centers (from the public regulatory apparatus, but also from the self-regulatory practices of private entities).[31] While only an indirect measure of regulatory capacity, it may also be significant that the Federal Reserve System produces and analyzes much more quickly the data that is relevant to understanding market trends than do central banks elsewhere.[32] Since the Basel Committee for Bank Supervision came into existence in 1974, either an American or an Englishman has chaired it for 19 years, by a Dutchman for four years, and by an Italian for four years.[33] It is interesting, given the strong norm of rotating power in many euro-centric institutions, that a central banker from Germany, Switzerland, France or Japan has never chaired this committee. An American with extensive supervisory and regulatory experience was recently chosen to chair the new Financial Stability

Institute, whose purpose it is to assist bank supervisors around the world in improving and strengthening their financial systems.[34]

The argument:

This concentration of financial power has profound implications for regulatory harmonization. The size of the internal United States market gives regulators there an incentive to take unilateral regulatory decisions, even if foreign regulators do not follow suit. The United States is "hegemonic" in finance in the sense that it is costlier to alter its preferred regulatory innovation than it is to try to change the policies of the rest of the world. US regulators can be thought of as *unconditional* first movers: financial regulatory innovation will be motivated by and respond to internal regulatory needs and politics (such as the soundness of the national financial system, the protection of domestic investors, improved transparency or efficiency or other social or political goals). Certainly regulatory decisions are taken subject to competitive constraints, but the size and efficiency of US financial markets and institutions often render such constraints non-binding. The framework developed here therefore takes US regulatory innovation itself as an exogenous expression of the domestic political economy. Virtually every political account of financial regulation in the secondary literature supports this assumption.[35] *International* policies of the dominant power, however, are formulated in response to or in anticipation of the reactions of the rest of the world to a particular regulatory change.

Whatever the content of the United States' regulatory innovation, enhancement, or deregulation, *it has the potential to change significantly the context for financial markets and hence regulators in the rest of the world*. Such a change does one of three things. It may (1) provide incentives for other regulators to *emulate* (implying a positive reaction function), (2) provide incentives for other regulators to *diverge* (a negative reaction function), or (3) have *no effects* on others.[36] One can think of this reaction function forming a continuum ranging from strong incentives to defect (resembling a collaboration game) to strong incentives to emulate (resembling a coordination game). In the middle of this range, strategic incentives are undefined, as the regulatory innovation of United States regulators does not change the conditions facing the rest of the world significantly.

We can summarize the impact of regulatory change in the dominant financial center by its effect on the profitability of firms operating in foreign jurisdictions. Emulation will be reinforced if the innovation renders non-conforming jurisdictions relatively costly or risky sites to conduct business. In this case, emulation would be a logical competitive move in order to maintain or attract business to the national jurisdiction. Access to the markets of the dominant financial center also provides a powerful market incentive to conform to their regulatory environment. In both of these cases, market pressures and opportunities that follow directly from the regulatory change in the United States encourage harmonization. When this is the case, the dominant power can afford to take a politically passive approach to international harmonization.

On the other hand, some regulatory changes can prompt divergent policy choices in foreign jurisdictions. This is most clearly the case when a regulatory policy taken elsewhere creates an economic premium for taking the opposite response. Economic sanctions provide a well-known example: a rule against providing goods or credit to a particular country in effect increases the (market) returns to those willing to defy the sanctioning coalition. Or imagine the effect on the price of a therapeutic drug in Mexico that has not been approved by the American Food and Drug

Administration. Assuming Mexican authorities have reached an independent conclusion regarding safety and efficacy, they have powerful incentives to make such a drug available, *especially* in light of its non-availability in the United States. In these cases, the market does not reinforce the regulation of the dominant jurisdiction. On the contrary it may raise the (opportunity) costs of harmonization.

The second dimension - the nature and extent of externalities – is essential to understanding the dominant financial center's international policies relating to a particular innovation. The key question is whether the rest of the world's aggregate equilibrium reaction creates a significant negative externality for the first mover. Because the dominant power has already determined that the regulatory innovation is in its own domestic interest, no combination of responses on the part of the rest of the world's regulators will cause it to alter its own internal regulatory stance. It will, however, anticipate costly foreign resistance to its regulations. If negative externalities are significant, the question the dominant financial center faces in formulating its international policies is how it can change the choices of other financial regulators at reasonable cost.

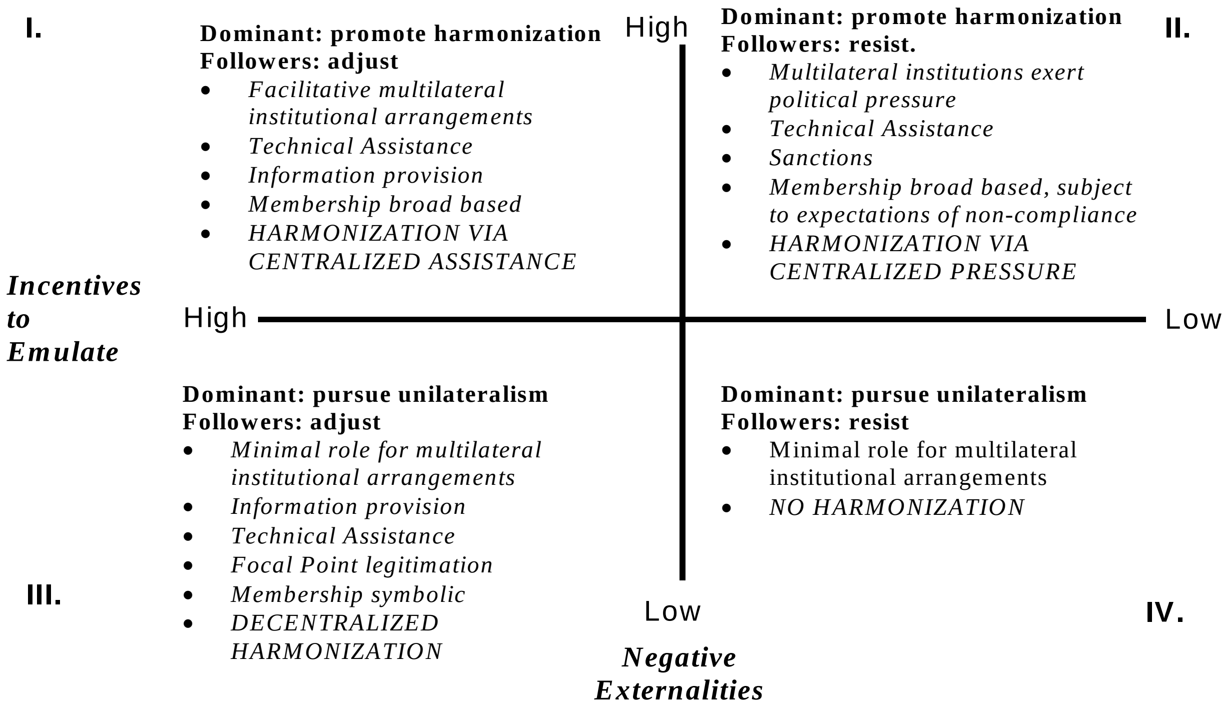
Suppose the world's reaction to the initial move causes a high negative externality for the first mover. Rather than meekly retract its regulatory innovation, regulators in the dominant financial center anticipate costly foreign resistance, and will mobilize political pressure to try and change the reactions of important foreign regulators. In fact, it would be reasonable to expend political resources up to the cost of the negative externality it is importing. If the negative externality is very costly, we should see the exertion of a good deal of political pressure on the part of the dominant financial power. We should also expect to observe efforts to minimize the costs of addressing these externalities. For example, if the sources of the externalities are distinct or if the externality is divisible we could expect the United States to target its pressure accordingly. Where the source of the externality is uncertain or constantly shifting, or where the externality is not easy to target, multilateral institutions might be a more efficient way to press for regulatory change in foreign jurisdictions. On the other hand, if the negative externalities experienced or anticipated by the dominant power as a result of the reactions of the rest of the world are small, there is no reason to expect a very active international component to the regulatory change. The United States should not care in this case whether the rest of the world adopts the policy innovation or not.

The role for multilateral institutions flow from the hegemon's anticipation of externalities. These institutions can be created and used strategically by the dominant financial center to achieve its desired regulatory outcome – the mitigation of negative externalities – in an economical fashion. Their strength and role should reflect the strategic problems of the dominant center. After all, collective action problems and disagreements over distributive issues render institutions built by opposing regulatory coalitions highly unlikely. Where multilateral approaches are unnecessary to avoid externalities in the center, this framework expects multilateral institutions to be weak, or at most facilitative rather than active enforcers of regulatory harmonization.

By combining these two dimensions– the extent to which foreign regulators have an incentive to emulate, along with the extent and nature of the externalities anticipated by the dominant financial center – it is possible to lay out the mechanisms by which harmonization is expected to come about, and the role for international institutions in this process (see Figure 1).

Figure 1: Expectations:
Incentives for Regulatory Harmonization (dominant power, followers)

II. Institutional Implications



In Figure 1, quadrant I, regulators in smaller jurisdictions have an incentive to emulate in a policy area in which the potential negative externalities for the dominant power are high. The dominant center supports these adjustments, due to the potential for negative externalities in the absence of harmonization. It is in the dominant center's interest to support the creation and activities of an international institution with broad-based membership encompassing the range of the sources of anticipated externalities. This institution need only play an informational role regarding the nature of the dominant financial center's standards, and may provide technical assistance to jurisdictions wishing to implement them. While these standards may not have been preferred in the absence of the dominant center's innovation, smaller financial centers have incentives to respond by adjusting their own regulations. In this quadrant, we should expect harmonization to take place primarily through market incentives and to be facilitated by the dominant financial center through an institution designed to bolster the technical ability of smaller jurisdictions to adhere.

Quadrant 2 has very different expectations. The key difference here is that smaller jurisdictions have an incentive to resist the financial center's regulatory innovation. Moreover, their reaction creates negative externalities within the jurisdiction of the dominant financial center. The dominant center, concerned to limit the impact on its national firms or at home, pressures smaller jurisdictions to match its financial regulations. One way to do this is through unilateral pressure, which is a reasonable response as long as the sources of the externality are stable and distinct. In some cases, the dominant financial center may be able to target or divert negative externalities at minimal cost; for example, bilateral agreements can be reached or unilateral action taken that mitigate the transmission of the negative externality from one jurisdiction to another.[37] However, in some issue areas, buying off one producer of a negative externality may only encourage the private entity that is the source of the externality to migrate to another jurisdiction. This is especially problematic when jurisdictions are highly substitutable for the kind of activity under consideration, and when curtailing the activity in some jurisdictions actually *raises* the payoffs to its few remaining (unregulated) practitioners. If these externalities cannot be targeted or diverted at reasonable cost, it is more rational for the dominant financial center to press for regulatory harmonization through the creation and backing of multilateral institutions that not only provide technical assistance (which would not be sufficient to convince smaller jurisdictions to harmonize their rules in this case) but also that exert overt political pressure on jurisdictions that do not comply.

Since defection problems often create incentives to misrepresent behavior, multilateral institutions under these conditions will often be essential in gathering "objective" information through surveillance protocols. International institutions will also be important to the dominant financial center for coordinating potentially costly punishments that might be subject to problems of free-ridership in their absence.[38] If externalities are not divertible, or if their source is uncertain or constantly shifting, (that is, if they approximate a “public bad”) we would expect membership in such an institution to be broad (with a caveat that it may be limited by a desire to include only those who can be persuaded through institutional mechanisms to comply).[39] If harmonization takes place, it will be through overtly political pressure from the financial center, most likely exercised through a multilateral institution.

Quadrant 3 predicts just the opposite. Smaller jurisdictions have market incentives to adjust to the regulatory change in the center, and the negative externalities anticipated by the financial center are minimal. Smaller jurisdictions have market motives to adjust, and the financial center has little incentive to respond at all. There is little reason to create an international institution in this case; harmonization is likely to proceed in a very decentralized fashion. Multilateral institutional arrangements that do develop are likely to do little more than provide technical assistance, or legitimate a “focal point”[40] that provides a multilateral veneer to an essentially unilateral decision taken in the dominant financial center. Market forces rather than overt political pressure will foster decentralized harmonization in this case.

Finally, consider the case in which smaller jurisdictions have no incentive to adjust their regulations in response to the center, yet the center experiences no externalities as a result of such resistance (quadrant 4). Smaller jurisdictions do not want to emulate, but the dominant center does not care. There is no reason to expect the dominant center to invest in multilateral institutions; nor should we expect harmonization to take place under these conditions. But if it does, the mechanisms will be political rather than market based.

It is worth pointing out how this framework differs from institutionalist theories that rest on more liberal functionalist formulations. There is nothing particularly “cooperative” or even Pareto-improving to this situation. Regulators elsewhere may not even have been consulted or have participated in any meaningful way in decisions that fundamentally alter their regulatory landscape. Smaller financial centers may have had to adjust to decisions taken by the United States to avoid worse outcomes, but may have preferred no innovation at the center to begin with.[41] Indeed, this framework predicts an important role for coercion and persuasion when incentives to diverge are strong and negative externalities are severe. Financial dominance of the United States precludes a return to the status quo as an option, even if that is what many smaller centers would prefer.

Furthermore, by taking both incentives to emulate as well as externalities into account, this framework is able to provide nuanced expectations based on the strategic context that can differ notably across sub-issue areas of finance. Much of the literature on international institutions has been inspired by the analysis of cooperation games versus coordination games. [42] Most of these analyses assume rough parity among the players and ignore the role that power and persuasion play in arriving at a stable equilibrium. The anticipation of externalities in this model provides the motivation for the dominant power to use political pressure to counter uncooperative behavior and to provide technical or other assistance to emulate (if necessary). The nature of externalities also allows for more nuanced predictions with respect to institutional form, with shifting, uncertain, or worldwide sources encouraging the dominant center to invest in multilateralism.

This framework also differs from theories that expect regulatory races to the bottom.[43] There are good reasons to expect dominant financial jurisdictions to function as “regulatory anchors” in the sense that they do not respond in kind to what may seem to be competitive regulations by foreign jurisdictions. Indeed, if the dominant financial center is large and competitive enough, it seems utterly arbitrary to assume that it will sacrifice its national regulatory preferences to engage in a downward competitive spiral with foreign jurisdictions. In this framework, I make the more reasonable assumption that a financial center as large and competitive as the United States is unlikely to reverse its domestically preferred regulatory course. This would not of course prevent races to the bottom among smaller or less efficient jurisdictions,[44] but does provide a backstop to the generalized regulatory deterioration sometimes alluded to in the literature.

III. Issue areas

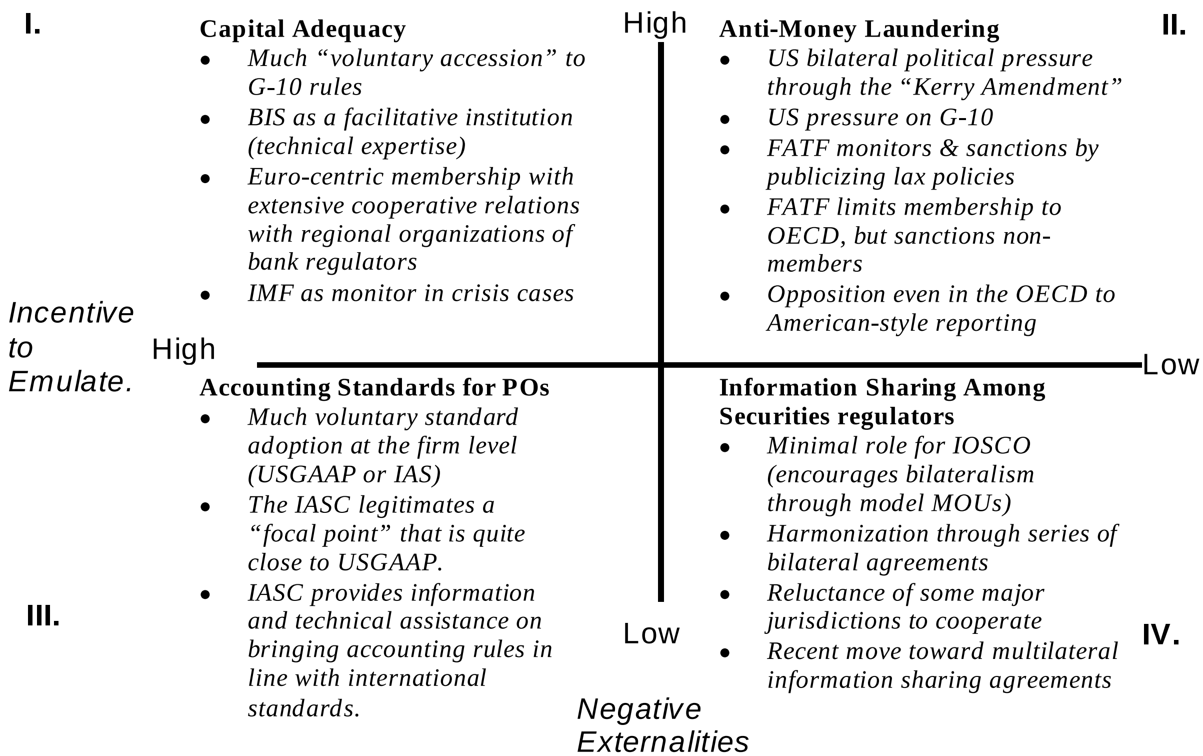
This section provides some evidence for the argument developed above. The research design is simple: I examine four sub-issue areas of international finance that are illustrative of the four different combinations of values on the key independent variables (incentives to emulate and the nature and extent of externalities). “Financial dominance” is constant throughout these cases. The central question is whether the mechanisms of harmonization (the relative role of market incentives versus political pressures) and the role of international institutions (whether they are unimportant or central to the harmonization process; whether they are designed to facilitate, legitimate, or enforce) fit the expectations I have set out above.

Quadrant I: High negative externalities, high incentives to emulate: the case of capital adequacy rules

The globalization of banking increases the possibility that any weak bank involved in the increasingly dense network of interbank relations potentially can transmit its weaknesses via the interbank market throughout the international banking system. One can gain an appreciation of these linkages by looking at the size of the interbank market: for banks in countries reporting to the Bank for International Settlements, between 1983 and 1997 interbank claims averaged about 58 per cent of total assets and interbank liabilities averaged about 62 per cent of total liabilities.[45] Furthermore, banks that are linked through the interbank market are highly leveraged, which raises "the possibility that failure of one bank to settle net transactions with other banks will trigger a chain reaction, depriving other banks of funds and preventing them from closing their positions in turn."[46] Capital adequacy standards are explicitly intended to "protect the safety and stability of the system as a whole"[47] from risky activities of weakly capitalized firms. Highly leveraged loans linked through a transnational interbank market make for an issue area in which the American banking system is potentially subject to the negative externalities of poor capital adequacy regulation in other parts of the world.

On the other hand, there are strong incentives to emulate an American regulatory innovation with respect to capital adequacy standards. The fundamental reason is that international banking is characterized by information asymmetries that provide an opening for opportunistic behavior. Rules regulating capital adequacy may convey important information on the quality of a firm as a counterpart to an agreement. In this environment, appropriate prudential regulations are a competitive advantage that other jurisdictions have an incentive to copy. In the words of the Chairman of the Federal Reserve Bank of Australia, once capital adequacy requirements are adopted by the Central Banks in G-10 countries, "…there is considerable [market] pressure on others to follow - otherwise their banks risk being perceived as somewhat inferior institutions in competitive situations."[48] A regulatory race to the bottom is conceivable in the absence of any obvious focal point,[49] but once the dominant financial center has adopted a clear standard, there is very little incentive to reduce standards and risk developing a reputation as "poorly regulated." Most banks are simply in no position to forego concerns about reputation and compete for international business on price alone. For this reason, strong incentives exist to emulate the standards adopted in the leading financial center. Capital adequacy standards are thus illustrative of the kinds of cases that fall into the upper left hand quadrant of Figure 2.

Figure 2: Harmonization and Institutional Outcomes



IV. Institutional Implications

Regulatory innovation in this area began in the United States in response to the savings and loans crisis of the 1980s. Worried by a trend toward capital deterioration despite growing financial risks associated with internationalization and liberalization - and the initial serious concern that differential approaches to capital requirements would constitute a competitive disadvantage for banks chartered in countries with more stringent requirements - the Federal Reserve and the Bank of England struck a bilateral agreement that provided for a common definition of capital. They agreed to adopt of a risk-weighting system for each class of assets, to include "off-balance sheet" items in risk determination, and adopted a formula for calculating specific capital requirements for individual banks, based on their weighted-asset risk profile.[50]

The case of capital adequacy standards fits the expectations of the proposed framework reasonably well. Strong market-based incentives have encouraged convergence in this area. The bilateral accord between the two largest players immediately sparked intense negotiations among the G-10 to adopt a common approach to capital adequacy. By some accounts, Japan, Germany, and France accepted the US/UK framework (with minor changes) because they were concerned that, without adjustment, their banks might not meet standards prevailing in the United States and United Kingdom.[51] In December 1987, central bankers from the G-10 countries adopted guidelines for evaluating the adequacy of capital in their international banks and agreed to reach an established minimum level by 1992. By the end of 1993, internationally active G-10 banks had capital ratios that *exceeded* the prescribed minimum, often significantly. [52]

By the mid-1990s the European Union had followed suit in their decision to use the G-10 guidelines as a basis for the Capital Adequacy Directive (CAD), which came into effect in January 1996.[53] Even more significant, a number of countries that did not participate in the G-10 process and have *no obligation whatsoever* to follow guidelines originating in Basel have voluntarily done so. Many developing countries have, for example, adopted the Basel Committee's 8 per cent capital adequacy rule for international banks. Others have decided unilaterally to match Basel rules regarding disclosure requirements for derivatives activities, citing G-10 rules as "global standards."[54] By 1994, every country out of the 129 surveyed by the BIS had capital requirements of some description, and in 92% of cases, a Basel-like risk weighted approach was reportedly followed. Capital charges for market risk exposure - a relatively new development - were imposed by 23% of the sample, and fully 85% of non-G-10 countries declared their intention to implement the 1995 Amendment to the original 1988 Capital Accord.[55] Even if these figures are exaggerated, they reflect an apparent desire to emulate the G-10's rules.

The process of rule development and dissemination has largely been market driven, though the Bank for International Settlements and more recently the IMF have played a facilitative role. Through meetings, informational conferences and technical training courses with regional central banking organizations, the BIS has actively supported the dissemination of G-10 prudential banking regulations and standards among emerging financial markets.[56] In the wake of the Asian financial crisis, banking supervisors in Indonesia have moved to phase in Basel's 8% capital adequacy ratio[57], despite the estimated price of recapitalization at this ratio of nearly 15 per cent of GDP.[58] Korea has also declared its intent to upgrade its prudential standards to meet Basel core principles, and mobilized trillions of won for purposes of recapitalization with the Basel ratios in mind.[59] Thailand adopted 8.5% recapitalization ratios for all surviving banks.[60] The explicit adoption of these targets has been essential for establishing the credibility of national bank reforms. To assist in the promulgation of its standards in the region, the BIS opened its first Representative Office outside of its headquarters in Basel in July of 1998.

No banking supervisor in the world has been able to speak of prudential regulations without reference to “international standards” which have spread from the initial US-UK agreement to the G-10 to the EU to a number of emerging markets. The BIS has provided technical assistance and promoted its rules as a focal point against which to judge the adequacy of banks’ capital ratios in jurisdictions around the world. Despite some effort by the IMF to subject adoption of these rules to some form of conditionality,[61] the market pressure to meet international standards has been far more important than has organized political pressure to harmonize these rules. Capital adequacy standards have become more rigorous and more widespread than a model of competitive regulatory laxity would suggest. It remains to be seen just how well these rules will be implemented, especially in the Asian financial centers whose restructuring is currently underway. But generally speaking, market pressures to match international standards have been far more important than political pressure, in sharp contrast to the case of anti-money laundering efforts, discussed below.

Quadrant II: High negative externalities, low incentives to emulate: the case of anti-money laundering

Money laundering supports a negative externality in the United States – criminal activity – that is extraordinarily difficult to eliminate, to target, or to divert. Estimates of the amount of money laundered provides an upper limit to the range of this externality: by some estimates, one billion dollars of criminal profits finds its way into the world's financial markets *every day*.[62] Estimates of the annual amount of drug profits moving through the United States financial system have been as high as $100 billion.[63] Michel Camdessus, former director of the International Monetary Fund, estimated that in 2000 the yearly global value of illicit money laundered was equal to between 2 and 5 per cent of world production.[64] Even if only a fraction of this total results from crimes affecting the United States, the potential negative effects are considerable. And as the recent case of the laundering of stolen aid to Russia indicates, the precedent crime does not have to be committed *in* the United States to frustrate broader American interests. Moreover, the situation will likely deteriorate as capital controls around the world continue to loosen and the scrutiny given international transactions continues to ease.[65] As evidence that the United States views money laundering as a serious threat, the Treasury Department operates the largest currency transaction reporting system in the world[66] at an estimated cost to the banking industry as high as $136 million annually.[67]

For a number of reasons, foreign jurisdictions tend not to want to emulate tighter anti-money laundering regulations. Indeed, stringent reporting requirements in the United States may make the banking secrecy offered by the legitimate private banking industry in such countries as Switzerland, Liechtenstein, and Luxembourg even more lucrative. Certainly, adopting tough reporting requirements could push funds offshore.[68] Swiss officials have long recognized that bank secrecy has contributed significantly to the high standard of living and thus "at least indirectly concerns substantial economic interests of the state."[69] In Liechtenstein, even mild rules regarding "due diligence " that require bankers to report suspicious activities to authorities "pose a direct threat to Liechtenstein's basic competitiveness," according to Bankers in Vaduz.[70] Developing economies may be even more resistant. Banking secrecy combined with loose supervision may be an attractive development policy for a large number of smaller resource-poor countries and territories. In an effort to jump-start an international financial services sector, some jurisdictions have instituted easy rules of incorporation, no recording requirements for large cash transactions, and a limited asset seizure capability. The fewer the jurisdictions willing to provide such services with minimal scrutiny, the better the terms these jurisdictions are likely to be able to extract from "investors." The conclusion in this case is quite different from that of capital adequacy regulation. Unlike the interest financial institutions may have in developing a reputation for safety, "...it is not necessarily in the direct financial interest of financial institutions to adopt anti-laundering behavior."[71] Anti-money laundering efforts provide no clear economic payoff, and may in fact exact immediate and unrecoverable costs to financial intermediaries.

As in the capital adequacy case, international initiatives to control money laundering have come primarily from the United States, in alliance with the United Kingdom, but also with France, and increasingly Australia.[72] By 1986, the United States was the only country to have criminalized money laundering, and it remains by far the leader in prosecutions.[73] Because most countries do not wish to emulate American policies, and because the externalities to the United States have been high, what harmonization has taken place has been driven by hardball political pressure. The US Congress began with the "Kerry Amendment,"[74] which required the US Treasury to negotiate with foreign countries with the objective of having foreign banks record all cash deposits over US $10,000 and to provide information to US authorities in the event of a narcotics related investigation. Should a bank fail to agree, the amendment gave the President the power to deny that bank access to the U.S.'s clearinghouse system. But for a number of reasons - including the universal nature of the problem, opposition from Treasury,[75] the fear of stimulating foreign alternatives to US clearing facilities, and the fear of retaliation against US banks – this unilateral approach fizzled with few tangible results.

It has been difficult for the United States to drum up support for its anti-money laundering crusade, but with Europe's eventual support the Financial Action Task Force (FATF) was created by the OECD countries in 1989. This is an institution that uses the only instrument at its disposal – peer pressure – to embarrass governments into adopting stricter controls over money laundering. The FATF uses a graduated set of sanctions to review and influence the policies of its own members and those of non-members to follow the spirit of its "Forty Recommendations" promulgated in 1990 (updated in September 1995). These recommendations call for states to ratify the 1988 Vienna Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, which specifies "intentionally" laundering drug profits as a criminal activity.[76] They also call on governments to adopt effective seizure and forfeiture laws, and to prohibit anonymous accounts. The FATF employs a system of mutual review in which each member's laws and efforts are scrutinized by a FATF team and then assessed by the full membership. The mildest sanction is a letter from the president indicating shortcomings in a particular country; the harshest sanction is expulsion. Turkey has been sanctioned – for several years it was the only country in the FATF that had failed to date to make money laundering a crime – and significantly changed its laws as a result.[77] The FATF's "Recommendation 21" also calls for sanctions against non-cooperative *non-members*. The Seychelles was one of the first countries to be on the receiving end of such a sanction.[78] The FATF routinely urges financial institutions to avoid doing business in countries with seriously wanting money laundering law, and posts the list of such jurisdictions on its website.[79] Meanwhile, the United States and United Kingdom often coordinate their bilateral pressure on uncooperative jurisdictions, and recently have denounced Antigua as unfit to conduct business with their national firms.[80]

The convergence across national jurisdictions since 1986 has been detectable but hard fought and far from complete. Almost all industrialized countries now agree that money laundering should be considered a crime, but few countries have embraced the American approach of comprehensive reporting of all cash transactions above $10,000 (most banks have lobbied their governments hard to reject US-style record keeping and reporting).[81] Tightening money-laundering rules continues to meet with significant resistance in much of the financially influential world. Outside of Japan, Singapore, and Hong Kong, money laundering is not a crime in much of Asia. Cooperation in the Western Hemisphere provides an interesting contrast: here sustained US leadership in such forums as the "Summit of the Americas" keeps laggards in the international spotlight. Many more Central and South American countries have made money laundering a crime, and have even agreed to "self-assessment" (though not mutual assessment, as in the FATF) in their own regional grouping, the Caribbean Financial Action Task Force (CFATF).

In short, harmonization with respect to money laundering depends on political pressure from the dominant financial centers. This follows from the nature of the issue area, in which emulation has its costs, and the negative externalities are high. Nor are these externalities easily controlled through unilateral efforts or by targeting individual jurisdictions. This provides incentives to create multilateral organizations with surveillance and enforcement powers. A multilateral institution, exerting strong peer pressure coordinated by the dominant centers, has been crucial to rule harmonization in this area.

Quadrant III: Low negative externalities, high incentives to emulate: the case of accounting standards for public offerings

National securities regulators formulate the conditions under which companies can offer their shares to the public on stock exchanges within their jurisdiction. Yet the accounting rules used to evaluate the worth of companies so offered can vary greatly from country to country. For example, when Daimler Benz first reconciled its accounts based on "United States Generally Accepted Accounting Principles" (USGAAP) as a condition of listing on the new York Stock Exchange, potential investors were stunned to learn that Daimler's *DM615 million profit* in 1993 under German accounting rules dissolved into a *DM1.8 billion loss* using USGAAP for the same period.[82]

Accounting standards for public equity offerings illustrate the conditions denoted in the lower left-hand quadrant of Figure 2. In common with capital adequacy standards, but in contrast to anti-money laundering regulations, there are significant incentives for regulators and firms to adopt the accounting rules of the major financial center. Because stock trading was originally influenced by time zones, this pattern is clear at the regional level.[83] Thus, Canada's standards tend to resemble those of the United States,[84] New Zealand's those of Australia, the Scandinavian countries those of Germany. Such coordination is useful in the absence of global, or even G-10 agreement. Disagreements emerge over which rules should be the international standard, but no national regulator has the incentive to differ radically from a major market, and once accepted, there are virtually no incentives to defect.[85] For internationally active firms, the transactions costs of keeping up to speed on multiple standards are likely to exceed the one-time adjustment costs to a single widely used standard no matter what its "nationality". Stock exchanges themselves want to attract as much high quality foreign business as possible, making them strong proponents of international standards.[86] As is the case with prudential regulations regarding bank capital, market pressures reinforce harmonization: once the adjustment costs are paid, there is no reason to buck the regulatory trend.

On the other hand, there are few if any negative externalities to the United States if other jurisdictions continue to use their own national standards for public offerings. In contrast to capital adequacy and anti-money laundering regulations, inadequate accounting rules may result in allocative inefficiency but are not discussed in terms of generating significant streams of negative externalities or serious systemic risks for the United States.[87] Widely varying accounting rules can add to transactions costs for firms that want to offer shares on foreign exchanges, potentially deter cross border listings (relatively few American firms list on the London and Tokyo exchanges, for example)[88], and confuse investors.[89] Negative externalities, however, have not been central to the definition of the problem for the dominant center.

Market dominance in equities is central to how harmonization takes place. Key is the fact that the Securities and Exchange Commission (SEC) insists that any firm listing in the US must use USGAAP. Market power alone has led to harmonization in this area: if companies want to list on American stock exchanges, they must be willing to pay the one-time adjustment cost. Many firms have prepared their statements voluntarily in order to maximize their access to international capital. Thus, in the last few years, there has been a trend by Swiss, French, and Belgian companies to adopt USGAAP or the somewhat less stringent International Accounting Standards (IAS) currently under development by the International Accounting Standards Committee (IASC).[90] In April 1996 Germany's fourth largest company, Veba, an energy and industrial conglomerate now moving into telecoms, adopted USGAAP, its CEO explaining, "It is a global capital market, and we all have to play by the same rules."[91] A raft of European multinationals, and most of corporate Germany, including Bayer, BASF, and Hoechst, and many companies awaiting privatization, including Deutsche Telekom, may seek New York listings and may have to opt for USGAAP standards before IASC standards are complete.[92] Interestingly, the newly established Easdaq – a pan European over the counter equities market established at the initiative of the European Commission – has opted to use USGAAP.[93] Harmonization in accounting standards for public offerings has been decentralized and market driven toward conformity with the rules of the dominant equities market.

Because the SEC knows firms that want to list on American exchanges are likely to be willing to pay the adjustment cost of reconciling their accounts to USGAAP, it has little incentive to foster international institutions to harmonize accounting rules. Thus, the International Accounting Standards Committee (IASC) has enjoyed little support from American standard setters, and in many respects has had to reconcile its “multilateral” rules to the demands of the SEC. After all, the IASC knows its standards have little credibility unless the SEC accepts them, and as one might expect, those rules that the SEC has accepted have been quite close to US practices.[94] All the while, tighter regional coordination among the Anglo-Americans outside of the IASC remains a live, indeed a thriving option.[95] Meanwhile, Britain has opposed standardizing accounting rules at the European level. The EU has instead pursued a policy of mutual recognition, and the European Commission has formally given up any effort to create a European Accounting Standards body.[96] Their strategy has been to try to influence the work of the IASC,[97] which is politically more palatable than accepting USGAAP without any pretense of multilateralism.

Harmonization has been driven in this case by decentralized market forces, primarily the desire to access the world’s most established equities markets. Firms adjust their accounts based on calculations of how much they would benefit from a foreign listing. Simple market power is moving harmonization toward the dominant center's preferred accounting approach. A multilateral accounting institution does exist, it does not explain harmonization in this area. Without much active American support, the IASC has provided the cover of multilateral legitimacy to mostly American standards. In doing so, they have provided a focal point that bears a close resemblance to SEC rules.

Quadrant IV: Low negative externalities; low incentives to emulate: information sharing among securities regulators

Internationalization of securities and related derivatives markets has made it nearly routine for advisers in one country to propose a trading strategy to a money manager in a second country which involves taking a position in a market in a third country, while offsetting it in a derivatives market in yet a fourth. When trading networks cross multiple jurisdictions, regulators' efforts to access information that would expose fraudulent or highly risky trading activities are greatly complicated. Information available only to foreign regulators is often essential for a national authority to perform its functions.

In order to prosecute fraudulent or risky securities trading behavior, regulators often need to harmonize their rules about the release of information that may be useful for that purpose. It is clear, however, that national regulators have reasons to resist making and honoring such agreements.[98] Often, concerns about confidentiality are important. In order to assess systemic risks, national regulators need to know foreign firms' market exposure and positions. Foreign regulators, under pressure from national firms, are typically very cautious in providing such sensitive information. When a request relates to illegal activities, there may also be concerns about attempts to exercise extraterritorial jurisdiction, especially if cooperation is sought to prosecute a foreign national trading from a computer screen in his or her own country. Agreements on the conditions under which information is to be shared among regulators do not provide market incentives for emulation.

Whether or not the United States is likely to experience serious negative externalities in this issue area depends on the reasons the information is sought. If it is for purposes of prosecuting securities fraud, negative externalities may exist, but are likely to be limited. In that case, the externality does not exhibit the same potentially global character as does money laundering, nor are there the same systemic risks posed by inadequate bank capital. When information is sought to prosecute fraud, this issue area belongs in the lower right-hand quadrant of Figure 2.

Increasingly, however, information sharing among securities regulators is viewed as crucial to detecting *systemic risks*. The collapse of Barings in 1995 did much to bolster this perception, even though no systemic consequences were in fact felt. Information that would have exposed Barings' dangerous aggregate position was compartmentalized in the Singapore and Osaka exchanges, and not readily available to any single regulatory body.[99] Revelations of how little anyone knew about Barings' total trading position is the reason that regulators have begun to view information sharing as essential to establishing the actual risk position of securities firms.[100] Thus, information sharing may be necessary to avert negative externalities of a more systemic nature. If so, this issue area may be migrating north toward quadrant II.

In the simple fraud case, there are no incentives to emulate, but neither is the dominant financial center likely to experience extensive negative externalities. The framework suggests little harmonization and a minimal role for multilateral institutions. The first part of this expectation is not quite met here: the issue area is in fact characterized by a series of bilateral agreements that represent a segmented form of harmonization. The prediction for the role of multilateral institutions does hold up. The relevant institution in this case is the International Organization of Securities Regulators (IOSCO), a relatively passive organization that has primarily encouraged regulators to negotiate and file their bilateral information sharing agreements. It provides technical advice where necessary and offers "model agreements" to interested parties.

The dominant financial center has proceeded bilaterally to secure understandings on information sharing for quite some time. U.S. regulators have negotiated a series of explicit bilateral information sharing agreements, modified somewhat depending on the circumstances, across an expanding set of dyadic regulatory relationships. Pioneered by the SEC in 1986, these agreements typically take the form of bilateral Memoranda of Understanding (MOUs). MOUs state the intentions of the parties to make information available under certain conditions, but are not legally binding. A typical MOU calls on each regulator to pass on information that gives rise to a suspicion of a breach of the laws of the other party. A few grant mutual authority for on-site inspections of fund managers in each other's jurisdictions.[101] By the end of 1997, United States regulators had on record with IOSCO more than 90 bilateral memoranda of understanding and similar agreements; British regulators had 45; French, 28; Spanish, 17; Italian, 14; Japanese, 4.[102] For reasons arising from its federal structure, German securities regulators have only entered into such agreements since 1995.[103] Out of 49 countries whose regulatory entities have entered into information sharing agreements, 21 made their first agreement with their counterpart in the United States. By the early 1990s, a number of securities regulators in emerging markets began to develop bilateral information sharing agreements as well. Securities regulators in China and Russia have now entered into such arrangements – first and foremost with the SEC.[104]

Clearly, there are some moderate externalities associated with the prosecutorial practices in other jurisdictions, but in this case, externalities are easy to target on a bilateral basis and prior to the Barings case were perceived to have no important systemic consequences. This explains the institutional response: bilateral agreements are easier to negotiate than multilateral accords, and minimize defection via specific reciprocity. As securities markets globalize, the incentive to replicate information sharing agreements increases, while the transactions costs of doing so declines (there are numerous tested "models" from which to select). Particular bilateral arrangements are invoked repeatedly between jurisdictions that transact a high volume of business, as is the case for example between the United States and the United Kingdom.[105] The key point here is that negative externalities are easily targeted; it makes sense in this case to negotiate agreements that constitute bilateral "club goods" that provide benefits (mutual access to information) for members only. Particularly in the prosecution of illegal practices, broad multilateral cooperation is not as important to the dominant financial center as having clear agreements with a few key regulators or exchanges.

Only recently have *multilateral* information sharing agreements been made, and as the framework presented here would suggest, these aim primarily to facilitate the detection of *systemic risks* that pose potentially far greater negative externalities for the dominant financial center. In March 1996, some 49 exchanges and clearing houses (14 of which are situated within the United States), as well as 14 regulatory agencies, signed international information sharing agreements which informally commit signatories to share market and financial information about members.[106] The expressed purpose is to allow a more comprehensive assessment of the inter-market risks. Thus, systemic concerns are beginning to make cooperation among securities regulators more closely resemble that among banking regulators. Arguably, this case has migrated from the lower to the upper region of Quadrant IV after 1995, indicating that harmonization of information sharing arrangements among securities regulators depends on the purposes to which the information will be put. Increasingly, these purposes have to do with averting potential systemic risks.

The framework offered here predicted little role for a multilateral institution in this issue area. After all, the segmented and targetable nature of the externalities arising from illegal trades makes bilateral arrangements more cost effective than broad multilateral approaches. As expected, IOSCO has been passive. They are not in the business of enforcing MOUs or even publicizing the extent of their use or patterns of compliance. Its innocuous role is reflected in its membership, which is ridiculously broad and practically little more than symbolic: about 95% of the world's exchanges belong.[107] In this issue area, enforcement is enhanced by bilateralism, which has the capacity to customize obligations and make expectations explicit, thus reducing defection, yet allows for face-saving ways to exit an agreement. As systemic concerns and the potential for negative externalities have increased, however, the SEC and major US exchanges have been willing to engage in multilateral commitments to share information on firms' trading positions.

III. Conclusions

Capital markets have developed so rapidly over the past decade that regulators have had to struggle to keep up with the changing markets they are charged to supervise. All across the regulatory spectrum, from bank supervision to securities regulation, from accounting requirements to anti-money laundering efforts, national authorities are finding that the ability to achieve their objectives at a reasonable cost is influenced by the action (or inaction) of their counterparts in foreign jurisdictions.

Power and influence in international finance is so asymmetric that we can understand the mechanisms of rule harmonization and the role of international institutions in this process with a fairly simple model. Essentially, once the dominant financial center initiates a regulatory innovation (which is exogenous to this model and is assumed to be determined by the domestic political economy), it is important to know two things. First, it is crucial to assess whether the rest of the world faces incentives to emulate or to resist regulatory change. Second, it is important to assess whether the negative externalities affecting the dominant financial center flowing from these choices are significant, and if so, whether they are easily targeted or diverted. The first condition explicitly acknowledges that foreign regulators' utilities can be either positively or negatively correlated with a particular regulatory innovation. If the former is the case, there will be market incentives to harmonize rules with those in the financial center. If the latter is the case, foreign jurisdictions may have incentives to implement regulations that run counter to those in the dominant financial center in order to collect a premium that the market is offering for services foreclosed by the regulatory innovation in question. Harmonization, if it is to occur, will require mechanisms that involve the use of political pressure, coordinated by the major financial center.

Externalities are central to this framework because they have much to do with whether regulators in the dominant jurisdiction have an incentive to pressure other regulators to conform. Thus they are central to a determination of whether the mechanism that accounts for harmonization flows from the market or from overt political pressure on the part of the dominant financial center. Moreover, we expected weak or merely symbolic international institutions where the dominant center experiences few negative externalities as a result of the rest of the world to its innovation. In this case, there is little reason for the dominant center to invest heavily in institutional infrastructure, and in the absence of such investments international institutions are not likely to be central to the harmonization process. As the application of the model developed, it became clear that it is also important to know whether or not negative externalities imported by the financial center are easily targeted or diverted. If not there may be an important role for broad multilateral institutions (subject to concerns about non-compliance if there are no market incentives to harmonize). But if so, bilateral arrangements can be effective without the dominant center expending resources to achieve compliance among a broad heterogeneous membership. When there is no market incentive for other jurisdictions to match the regulatory change in the dominant financial market, and this incentive leads to choices that impart negative externalities to the dominant center, international institutions are not only likely to be multilateral. They are expected to perform important surveillance and sanctioning functions as well.

This simple model is reasonably successful at explaining the mechanisms through which harmonization is achieved, and the role (if any) that international institutions play in this process. It helps to understand why a surprising number of national banking supervisors have been willing to adopt the Basel Accord's approach to capital adequacy standards: markets virtually demand it as an indicator of a "well-regulated" jurisdiction in an uncertain and asymmetrical informational environment. The major financial centers support the dissemination of these standards through the technical help and informational role of the Bank for International Settlements. The framework is also useful in understanding why harmonization has been a slow, partial, painful, and highly politicized process in the area of anti-money laundering rules. Emulation in that area is costly yet the United States is determined to address crime at home by enlisting often reluctant foreign jurisdictions to help ensure that crime does not pay. The United States has been central to the creation of an institution – the Financial Action Task Force – that can pass judgment on and sanction both members and non-members. Accounting standards for public offerings provides a good example of incentives to emulate combined with low negative externalities for the United States. Predictably, market forces have fueled harmonization and the efforts of the International Accounting Standards Committee have largely served to provide international legitimation for standards very close to those upon which the SEC has insisted. The most uncomfortable fit was found in explaining the outcome with respect to rules on information sharing among securities regulators. In retrospect, I have probably underestimated the externalities associated with the unwillingness of foreign regulators to cooperate in prosecutions by of fraud by providing needed information to the SEC. While limited, the externalities are not likely to be zero. Moreover, American regulators have found a relatively low-cost way to address what is essentially a private negative externality: strike a series of informal bilateral deals with the most significant jurisdictions and rely on specific reciprocity for enforcement. Increasingly, as information sharing has been needed to assess systemic risks with broader indivisible negative externalities, as the framework would predict, agreements have become more multilateral in their scope and more institutionalized in their provisions.

The attractiveness of this model in understanding regulatory harmonization generally will depend on its ability to "travel" convincingly to other issue areas. The strong asymmetry among financial jurisdictions may seem at first somewhat inappropriate for other issues such as environmental or labor regulations. Yet on closer examination it may not be inappropriate. The dominance of the financial center in this model serves to remind us that large jurisdictions take actions that correspond to their nationally determined preferences, and that these regulatory choices are not likely to be retracted simply because other jurisdictions have not chosen to emulate. It seems reasonable to assume that asymmetries are significant enough in a number of other areas to warrant such an assumption. Across a range of regulatory cases it should be possible, in principle, to ask whether the choices made by a major jurisdiction provide incentives to emulate, to diverge, or make no difference to other countries. Furthermore, whether or not the externalities are strongly negative enough for the dominant jurisdiction to respond with political pressure seems to transfer readily to other regulatory domains. The real difficulty in applying this approach is the inherent difficulty one has in specifying in advance just how costly a negative externality is likely to be in any given issue area. How, for example, can one rigorously quantify the (potential) externality imposed on the United States if other jurisdictions do not follow Basel standards of prudential banking supervision? Economists might be able to offer a theoretical response having to do with the cost of returning to the status quo, but actually measuring externalities will often be extremely complex.

Nonetheless, the framework offered here suggests two crucial dimensions that help explain the mechanisms behind observed regulatory harmonization. The first is incentives that smaller jurisdictions have to emulate changes taken by regulators in major markets. These incentives these incentives vary by issue area, as the research presented here reveals. This is one reason why competitive races to the bottom occur with less frequency than some analysts expect. The second important dimension is the nature and extent of externalities that affect an actor large enough to shape the role and strength of international institutions (if any). Neoliberal institutionalism to date has not provided a convincing explanation for the kinds of institutional variations this framework addresses. Moreover, analyses inspired by liberal functionalist approaches have played down important differences between market pressures and political pressures to harmonize policies, and have emphasized joint gains while submerging the more coercive aspects of "cooperative" arrangements. This framework brings these issues to the fore, and helps to make sense of a bewildering array of agreements, institutional arrangements, and unilateral practices designed to address the problems posed by rapidly changing international capital markets.

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Footnotes:

[1] Figures exclude the United Kingdom.

[2] IMF Global Portfolio Investment Survey, http://www.imf.org/external/np/sec/nb/2000/NB0008.HTM

[33] IMF1999, Ch. 2 Box 2.2.

[4] BIS 1998.

[5] BIS, *International Banking and Financial Market Development*, various issues, and ISDA statistics.

[6] BIS 1999.

[7] Cerny 1993.

[8] Strange 1996.

[9] For a summary of the basic purposes of financial regulation, see Herring and Litan 1995: 50.

[10] Keohane 1984.

[11] The focus here is not to explain the specific content of regulatory regimes.
[12] Thomsen 2000, p. 6.

[13] The most specific disaggregation of the service sector conventionally available includes finance, insurance and real estate (FIRE). See United States Department of Commerce 1998. (NIPA, table 601c, "National income without capital consumption by industry", line 16). http://www.lib.virginia.edu/socsci/nipa/nipa.html

[14] World Bank 2000, 260-261.

[15] OECD 1997, as cited by OECD 1998: 131.

[16] As of April 2000. The three American banks are Citigroup, Bank of America, and Chase Manhattan. *Economist*, April 18, 2000, p. 82.

[17] The 25 biggest foreign banks in the world keep roughly 5.6% ($536 billion) of their assets in the United States. *International Banking Regulator*, July 29, 1996, p. 4.

[18] Financial intermediation services and auxiliary services between residents and non-residents, including: commissions and fees for letters of credit, lines of credit, financial leasing services, foreign exchange transactions, consumer and business credit services, brokerage services, and underwriting services.

[19] OECD 2000.

[20] BIS 1997(?) Table 13, p. 136. The United States and United Kingdom accounted for 240 thousand settlements messages through the Society for Worldwide Interbank Financial Telecommunications (S.W.I.F.T.) while the rest of the G-10 *together* accounted for 290 thousand such messages.

[21] In May 2000, the London Stock Exchange and Deutsche Börse announced plans to merge to create "iX" - international exchanges. US based Nasdaq has signed a memorandum of understanding with iX - international exchanges to create a pan-European high-growth market. According to the announcement, iX will be headquartered in London, with major operations in Frankfurt. London Stock Exchange Press Release, http://www.londonstockexchange.com/press/story.asp?id=1

[22] *Economist*, July 8, 2000, p. 77.

[23] New York Stock Exchange, 1999, p. 3.

[24] New York Stock Exchange, 1999, p. 6.

[25] London Stock Exchange website, http://www.londonstockexchange.com/international/default.asp

[26] Economist, June 17, 2000.

[27] New York Stock Exchange, 1999, p. 4.

[28] Negotiable certificates issued by a US bank for shares of stock issued by a foreign corporation. The securities are held in a custodial account, usually in a foreign bank, while the depositary receipt itself is registered with the Securities and Exchange Commission, and give the holder the same benefits of ownership as a shareholder.

[29] *Economis*t, January 15, 2000, p. 77.

[30] Futures Industry Association Data; Bank for International Settlements.

[31] As a "self-regulatory organization" the NYSE has a sophisticated computerized program for detecting suspicious trading activities, and has been active in investigating activities that break its own regulations. This task is performed using the Automated Search and Match (ASAM), which contains the names of 800,000 executives, lawyers, bankers, and accountants, plus public profile data on officers and directors of approximately 80,000 public corporations and 30,000 corporate subsidiaries. Between 1992 and 1999, 176 cases on an annual average basis were referred to hearings panels for disciplinary action. NYSE website.

[32] According the to the Economist, the Federal Reserve System is much faster at collecting and analyzing data than is the European Central Bank or the Bank of Japan. *Economist*, April 22, 2000, p. 74.

[33] The Basel Committee on Banking Supervision has been chaired as follows: 1974-1977: Sir George Blunden (Executive Director of the Bank of England); 1977-1988: W.P. Cooke (Associate Director of the Bank of England); 1988-1991: H.J. Muller (Executive Director of de Nederlandische Bank); 1991-1993: E. Gerald Corrigan (President of the Federal Reserve Bank of New York); 1993-1997: T. Padoa-

Schioppa (Deputy Director General of the Bank of Italy); 1977-1978: T. de Swaan (Executive Director of de Nederlandische Bank); and 1998-present: William J. McDonough (President and Chief Executive Officer of the Federal Reserve Bank of New York). A history of the Committee can be found at http://www.bis.org/publ/bcbsc101.pdf.

[34] The FSI was formed in 1998 by the Bank for International Settlements and the Basel Committee on Banking Supervision. Its chair is John Heiman, whose resume includes a Directorship at Merrill Lynch, US comptroller of the Currency, the Federal Deposit Insurance Corporation, and the New York Federal Reserve.

[35] Sobel 1994 a and b, Reinecke 1995, Oatley 1998.

[36] Pahre 1999.

[37] However, as Ken Oye (1992, 26) has noted, every diversionary agreement increases the expected negative impact that the externality will have on other jurisdictions, creating a strong incentive to strike bilateral deals with a number of foreign regulators.

[38] Martin 1992b.

[39] Downs and Rocke, 1995. They argue that since enforcement of agreements can be costly, there are informational conditions under which exclusion of some "relevant" players from international agreements is reasonable, even though they may be producers of negative externalities. Uncertainty over compliance conditions any expectation of a direct relationship between the extent of externalities and the scope of participation in formal harmonization.

[40] This is the function that Garrett and Weingast (1993) emphasize in the case of the European Court of Justice.

[41] See for example Gruber 2000.

[42] Stein 1983, Snidal 1985, Martin 1992a. Krasner (1991: 364) notes, however, that there has been little effort to classify existing international regimes by the nature of the problem, reinforcing a tendency to emphasize prisoners' dilemmas over coordination games.

[43] The "race to the bottom" thesis is usually intended to convey the idea that in a competitive situation regulatory standards tend to fall below an optimal level, and not that they literally crash to the level of the lowest existing national standard. The thesis is propounded in a number of issue areas, including environmental standards (Porter 1999), corporate law (Daniels 1991), and capital adequacy standards (Bradley 1991 and Worth 1992). However for critical analysis and contrary findings in the areas of trade and finance respectively, see D. Vogel 1995 and S. Vogel 1996.

[44] See for example Porter 1999.

[45] Bank for International Settlements website, www.bis.org

[46] Fitch 1993: 600.

[47] E. Gerald Corrigan, President of the Federal Reserve Bank of New York, 1990.

[48] B.W. Fraser, Governor of the Reserve Bank of Australia,1995. Note that this does not imply a linear relationship between higher capital adequacy standards a reputation for safety. At some point (which even large banks and regulators would find it difficult to specify) the costs of holding capital in reserve exceeds the value of the added safety, and no longer contributes in any meaningful way to a safe reputation. Thus, there is little danger of a "race to the top": banks' competitive attempts to top one another's capital adequacy ratios indefinitely.

[49] Kapstein 1989: 324.

[50] Kapstein 1989: 323-347, Reinicke 1995.

[51] Kapstein 1989: 340-341.

[52] Tommaso Padoa-Schioppa, "Banking Supervision in a Global Market," Vienna, October 1994.

[53] John Tattersall, "CAD - Implementation," *Foreign Exchange and Money Market*, May/June, 1995, p. 28. This has not been without some complications for the EU, since they are in the business of creating binding directives with which national legislation must be brought into conformity, a process that can barely keep up with the changes in regulatory recommendations coming out the group of G-10 central bankers (and in fact may not be optimal given the high degree of technical uncertainty and the value of incomplete contracting in this area). Harmonization has also been complicated by the fact that the G-10 focuses its attention on large money center banks, while the EU necessarily crafts directives for large and small banks that comprise national banking systems.

[54] White 1996, p. 22

[55] Survey results are cited by Padoa-Schioppa 1996.

[56] White, p. 22; Padoa-Schioppa, 1994.

[57] All banks were to achieve a minimal capital adequacy ratio of 4% by the end of 1998, rising to 8% by the end of 1999 and 10% by the end of 2000. Banks that did not meet these ratios were subject to sanction by the Bank of Indonesia. IMF website, www.imf.org

[58] Part of this figure includes repaying the Bank of Indonesia for provision of liquidity, and much is expected to be recovered as recapitalized banks are sold. Memorandum of Economic and Financial Policies, Indonesia, 10 April 1998, IMF website, www.imf.org

[59] Korea Memorandum of Economic Policy, November 1998. IMF website, www.imf.org

[60] Thailand, memorandum of Economic Policy 25 August 1998. IMF website, www.imf.org

[61] Meeting Basel standards is included in every discussion of financial and economic plans among the Asian countries seeking IMF assistance, but the IMF does not consider prudential banking standards to be among its "core responsibilities", and thus collaborates with the BIS on dissemination of these principles. The Fund has however, intensified efforts to use Article IV consultations to promote these rules. IMF 1998.

[62] Estimate given by Eduardo Vetere, head of the Crime Prevention and Criminal Justice Branch at the opening sitting of the European Regional Preparatory Meeting for the 9th UN Congress on Crime Prevention and the Treatment of Offenders (1995); 28 February 1994, Vienna.

[63] www.ustreas.gov/fincen/border.html

[64] *Economist*, July 1 2000, p. 70.

[65] See testimony in April 1989 the Governor of the Bank of Italy, quoted in Gurwin 1990. See also Tanzi 1996.

[66] www.ustreas.gov/fincen/follow1.html

[67] This is an industry estimate. Powis 1992.

[68] Troshinsky 1996, p. 1 and 6. On the size of the private banking industry in Switzerland see Rodger 1995.

[69] This statement is a translation of official Swiss Federal Government policy, quoted in Aubert, Kernen and Schoenle 1978:59. (Translation from a summary generously supplied by an official of the International Monetary Fund.)

[70] *Euromoney*, July 1996, p. 151.

[71] Quirk 1996: 24.

[72] With one of the most technologically sophisticated methods for detecting financial patterns associated with illicit activities, Australian authorities have used their own forfeiture funds to establish a secretariat for the Financial Action Task Force (FATF) in Asia. Discussion with officials from the US Treasury and FINCEN, 5 and 8 August 1996.

[73] Between 1991 and 1993 the number of cases filed and tried under Title 18 USC 1956 or 1957 approximately quintupled. In 1993, 822 cases were filed and 106 tried. Justice Department figures, reported in Courtney 1994.

[74] Section 4702 of the 1988 Omnibus Drug Bill. See also Crocker 19xx.

[75] United States Congress 1990, p. 28. This opposition was also confirmed in an interview with a Treasury official, 7 August 1996, Washington DC.

[76] The Vienna Convention (20 December 1988), Article 3, section 1, (b) (i) and (ii).

[77] Interview with a Treasury Official, August 5 1996, Washington DC.

[78] In February 1996, the FATF vigorously and publicly opposed provisions of that country's "Economic Development Act" which guaranteed anonymity, immunity from criminal prosecution, and protection of all assets to anyone who invests more than $10 million in approved investment schemes in the

Seychelles. The (American) FATF president publicly termed the Act "an incitement to criminals throughout the world to use the Seychelles as a clearing bank for their illegally acquired gains with full immunity." Quotations reported by AP, Worldstream, International News, dateline Paris, 1 February 1996; and in "We love the EDA," *The Indian Ocean Newsletter*, No. 705, 10 February 1996. Seychelles' defense of the law is reported by Litchen 1996, p. 17.

[79] Countries currently so listed include nine island countries as well as Israel, Lebanon, Liechtenstein, Panama, Philippines, and Russia. http://www.oecd.org/fatf/pdf/NCCT2000-en.pdf, p. 12.

[80] *Economist*, July 1 2000, p. 70.

[81] R.D. Fullerton, Chairman and CEO, Canadien Imperial Bank of Commerce, Toronto,1990.

[82] *The Economist Intelligence Unit*, 5/13/96. *New York Times*, 16 December 1993; *New York Times*, 31 March 1993, Section D, p. 8.

[83] Jean-Francois Theodore, Chairman and Chief Executive, SBF-Paris Bourse, 1995.

[84] Associate Chief Accountant, Securities and Exchange Commission, interview by telephone, Washington DC, 13 August 1996. American and Canadian accounting boards routinely coordinate their standard setting, often jointly publishing drafts and reports. See also *Financial Times*, 30 May 1996, London Edition p. 28.

[85] One might object that there are incentives to diverge from foreign standards that are patently inferior to those currently promulgated nationally, but this is very unlikely to be the case. Major markets are only likely to develop in the presence of reasonable regulatory regimes (Sobel 1999), minimizing the theoretical possibility that small markets might have objectively justifiable reasons to prefer their accounting rules over those prevailing in a major market.

[86] Interview, Official of the New York Stock Exchange, New York City, 8 November 1995.

[87] See for example the discussion in the introduction to Bloomer 1996.

[88] Sobel 1994.

[89] Michael Sharpe, Chair of the International Accounting Standards Committee (IASC). 1995. There continues to be a divide between the “Anglo-American” versus the “Continental” approaches to accounting, which in turn have histories rooted in the way firms have traditionally been financed. The former stresses the shareholders' need for information about earnings and profitability, and is common where capital markets have traditionally provided the major source of external financing for firms. Countries using in this school include the United States, United Kingdom, Australia, New Zealand, and the Netherlands. On the other hand, a number of countries, especially in continental Europe, use their tax books as the basis for financial reporting, which tends to mingle signals about a firm's profitability with its tax accounts, and focuses on the long run source of income rather than profitability per se. Countries with accounting standards that fit this description include Germany, the Scandinavian countries, France, Belgium, Italy, and Spain. Cummins, Harris, and Hassett 1994: 27.

[90] Sharpe 1995.

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[91] *Economist Intelligence Unit*, 15 April 1996.

[92] *Economist Intelligence Unit*,13 May 1996.

[93] See the EASDAQ's rulebook which is found at http://www.easdaq.com/pdf/rulebook.pdf

[94] Official at the NYSE, Interview, 8 November 1995, New York.

[95] American standard setters, notably the Financial Accounting Standards Board (FASB) remain deeply skeptical of the IASC, and continue to nurture the Anglo-American accounting alliance through the "Group of 4+1" countries - the US, UK, Australia, and Canada, plus an IASC representative. In the view of American standard setters, it is crucial to continue a dialog with this group of "like minded" standard setters, and not to count on progress at the IASC, which is viewed as far more likely to promulgate stretchy rules unacceptable to the US. The strategy of US standard setters has been to make as much progress as possible in the Group of 4+1 so that the Europeans are persuaded to participate essentially on Anglo-American terms. Interview by telephone with Vice Chairman of the Board, FASB, Norwalk, CT. 15 August 1996.

[96] *Economist Intelligence Unit*, 13 May 1996; *The Financial Times*, 6 June 1996, London Edition, p. 29.

[97] See the comments of Mario Monti, Commissioner, European Commission,1995.

[98] Interview with Special Counsel for International and Regulatory Affairs, Trading and Markets Division, Commodities and Futures Trading Commission, by telephone, Washington DC, 22 August 1996.

[99] See *Financial Times*, July 19, 1995 p. 7.

[100] *International Securities Regulation Report*, 28 March 1996, p. 3, 13-14, for an interview of Simona Locatelli, Derivatives Division of the Italian Stock Exchange Council.

[101] SEC and the U.K.'s Investment Management Regulatory Organization (IMRO) signed such an agreement in May 1995. *International Securities Regulation Report*, 25 May 1995, p. 9.

[102] Website of the International Organization of Securities Regulators (IOSCO), www.iosco.org

[103] Prior to 1995, this was due to the fact that supervision of Germany's eight exchanges was a responsibility of the federal states. The Bundesaugsichtsamt fur den Wertpapierhandel (BAWe) now has the authority, but prefers to cooperate on a project by project basis. Georg Wittich, President, Bundesagusichtsamt fur den Wertpapierhandel, 1995.

[104] Russian regulators' first and Chinese regulators' second such agreement (after one with Hong Kong authorities) is with the United States Securities and Exchange Commission. Both concern technical cooperation, mutual assistance and consultation between the SEC and the Russian and Chinese counterparts. IOSCO website, www.iosco.org.

[105] Interview with Special Counsel for International and Regulatory Affairs, Trading and Markets Division, Commodities and Futures Trading Commission, by telephone, Washington DC, 22 August 1996.

[106] Due to national regulatory structures, Japanese authorities were not able to sign the agreement, triggering criticisms that country's national laws were hampering international cooperation among regulatory authorities. Italian regulators signed, but the Italian Stock Exchanges could not because they are not allowed to engage in surveillance of their members. The MOU does, however, allow signatories to join the agreement at a later date, and Japan is expected to do so. See *International Securities Regulation Report*, 28 March 1996, 9:8, p. 1 and 8.

[107] Eduard Canadell, Secretary General of IOSCO, 1995.