The Choice between Formal and Informal governance in the areas of Currency and Trade: A Two-Level Approach

version 1.5 January 2012

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Paper written for the 5th Conference on the Political Economy of International Organizations (PEIO V) at Villanova University, January 26-28, 2012.

Abstract

States that seek to cooperate have a choice between formal—treaty-based—and informal forms of cooperation—transgovernmental network or private governance. The choice between formal and informal, it is argued, is a function of the nature of the externality: whether it is a purely cross-border externality or a cross-border externality that also has a domestic component—a two-level externality. In the former case, states prefer to set up a treaty-based regime; in the latter case, states have a unilateral interest in reducing the externality on their own, with the effect of creating an informal regime in which intergovernmental interaction, if any, is limited to being a by-product of domestic policy. The paper analytically works out the domestic dynamic of each case to generate general claims which are then used to revisit the history of the trade and currency regimes.

Acknowledgements

I wish to thank Alexander Thompson for his comments on multiple earlier drafts.

1 Introduction

More than a century ago, in 1893, at hearings before a Democratic-controlled Ways and Means Committee, the American Iron and Steel Association asked for the maintenance of high tariffs on iron and steel products. They were successfully opposed, among others, by farmers, whose free trade preferences prevailed in the 1894 Wilson-Gorman tariff passed under the Cleveland administration.[1] Less than ten years ago, in 2003, the Bush tariffs on imported steel, which had been imposed to counter dumping alleged by U.S. steel makers, were lifted after the Dispute Settlement Body of the WTO, seized by the European Union and six other countries, ruled against their legality.[2] The relative freedom of trade in steel products was enforced through the mobilization of a domestic coalition in 1893 but of an international coalition in 2003.

More generally, picture a government toying with the idea of manipulating its currency in order to reduce the burden of the public debt and further give its national industry a momentary advantage over trade rivals. There are two sets of interests at least that are bound to lose from such a move and who could, if mobilized, make it hard for the government to carry out the projected manipulation: foreign exporters and creditors on the external front, and domestic consumers and creditors on the internal front. Which of these two fronts, domestic or external, is more likely to get into action?

Interesting in its own right, the question of whether it is international or domestic pressure that insures orderly behavior in currency and trade regimes also has far-reaching implications for another topic that has assumed pride of place in the recent literature: The rise of informal governance as an alternative (or complement) to formal treaty making and the rationale for choosing one

[1] U.S. Congress, House Committee on Ways and Means 1893.
[2] Sanger, David E. "Backing Down on Steel Tariffs, U.S. Strengthens Trade Group." The New York Times, (December 5, 2003)

instrument over the other. Indeed, consider the second scenario above. The foreign exporters and creditors can only stop the intended currency manipulation through the intervention of their own government, an intervention which is made possible if the two governments already are bound by an agreement to ban such manipulation. In contrast, domestic creditors and consumers have direct access to their own government, allowing them to veto the manipulation in the absence of any foreign entanglement other than informal talks between central bankers on the coordination of an eventual joint action. The former venue calls for a treaty; the latter is content with informal governance. Which is more likely to obtain?

This is the question that I seek to answer in the present paper. I borrow from the growing literature on governance, which contrasts two opposite forms of regime, treaty-based (involving legal commitment and enforcement) and informal (involving none of the above), to code the evolution of the trade and currency regimes over the last 150 years. In accordance with the literature, I further distinguish between two categories of informal governance: transgovernmental networks, which include government participation, and private governance, which does not.

I try to explain the evolution that took place in the trade and currency regimes by means of a general argument with relevance beyond these two regimes. The argument rests on a simple proposition. States reduce a cross-border externality by internalizing that externality. If the externality is purely cross-border, states do this by negotiating a treaty-based regime mandating the reduction of the externality and setting up an appropriate enforcement mechanism. But if, in addition to its cross-border dimension, the externality also displays an internal dimension, for instance the domestic production of the externality victimizes domestic groups in addition to foreign countries, then governments have a unilateral interest in reducing the externality on their own at home, with the effect of creating an informal regime in which intergovernmental cooperation, if any, must be flexible enough to remain in sync with domestic policy. I call the second type of externality a "two-level externality."

The paper builds around this core idea, using the trade and currency cases to work out the domestic dynamics of a two-level externality and drawing from this discussion plausible and testable theoretical claims about the circumstances in which such externalities arise and provide the basis for the formation of an informal regime as opposed to a treaty-based regime.

I first review the current literature on state's regime preference. I then develop my argument and apply it to the trade and currency regimes over the last 150 years. The historical foray constitutes a test of the plausibility of the argument but not of its validity.

2 Current literature

The distinction between formal and informal governance originated in two very different corners of the governance literature: (1) private governance, not involving governments, and (1) transgovernmental networks, involving governments.

Private governance involves NGOs and business corporations agreeing on the implementation of codes of conduct or certification schemes that not only have no legal force but are negotiated, if not enforced, without government participation.[3] The resulting international regime results from a process that combines market with social mobilization in a handful of countries. Examples include the campaign led by Global Witness and Partnership Africa Canada against DeBeers and the diamond industry at large, leading eventually to the

[3] On private governance, see among others Haufler 2001, Kern et al. 2001, Cashore 2002, Khagram, Riker, and Sikkink 2002, Cutler 2003, Koenig-Archibugi 2004, Kolk and van Tulder 2005, Vogel 2009, Green 2010.

Kimberley Process Certification Scheme (Haufler 2001).

Transgovernmental networks, also known as "networked governance," constitute regimes that often are negotiated between lower government levels, typically a department or ministry or agency endowed with regulatory power, sometimes with a sprinkling of experts drawn from the business world.[4] The agreements, also dubbed "accords" and "memoranda of understanding," have no legal force. Negotiations are limited to revealing a shared understanding of the problem and solutions at hand rather than constructing an elaborate quid pro quo. The Proliferation Security Initiative to interdict the shipment of nuclear technology to Iran and North Korea and the multiple Basle Agreements on capital adequacy are two instances of transgovernmental networks.[5] Many networks have aims that are limited to the diffusion of information among government agencies or the training of foreign regulators into the latest "best practice" (for instance, the INECE on environmental enforcement).

The starting point for the literature on private governance—the displacement of government regulation by private regulation—is primarily domestic in nature. The recent rise in globalization is seen as the cause of "regulatory failures" to which the recent expansion of "industry self-regulation" is a political response.[6] Haufler (2001; 29) writes that "where governments do not govern, the private sectors does..." Firms are motivated to take the initiative and self-regulate for fear of government regulation and to enhance their reputation among consumers, while politicians are happy to achieve public ends without having to act against the private sector.

Another source of regulatory failure is the WTO sweeping interdiction of

[4] On transgovernmental networks, see, among others, Keohane and Nye 1974, Dehousse 1997, Raustiala 2002-03, Slaughter 2004, Kerwer 2006, Lipson 2005/2006, Eilstrup-Sangiovanni 2009, Josselin 2009, Mosley 2009, Speyer 2009, Kahler and Lake 2009, Verdier 2009, Helleiner, Pagliari, and Zimmermann 2010.

[5] On Basle, see Mosley 2009, Speyer 2009, and Verdier 2009. On the Proliferation Security Initiative, see Eilstrup-Sangiovanni 2009.

[6] Reinicke 1998, Haufler 2001, Kirton and Trebilcock 2004, Vogel 2009.

any non-trade-related interference with trade. The WTO bans trade sanctions for non-trade related reasons, but it says nothing about voluntarily-agreed civil regulation.[7] LDCs who disagree with eco-labels and certification schemes have no legal recourse under the WTO.

Linked to the rise of globalization is the shift toward a neoliberal ideology that, first, deligitimized state intervention in the economy and, then, created governance gaps and regulatory failures, for which the private sector and social actors sought to compensate.[8] Also mentioned among seeding historical trends is the declining fiscal capacity of the state.[9]

The growing transformation of state regulation into business self-regulation, although a domestic trend, has international consequences when the business in question is constituted of transnational companies with oligopolistic control over their respective sectors. In such a case, using the threat of consumer boycott to leverage a change in the way these companies conduct their business has implications for their suppliers and markets around the world that are tantamount to the creation of a private international regime.

Coming from a different direction is the literature on transgovernmental governance, where the underlined change is not the privatization of regulation, but the substitution of informal international agreements for formal treaties. First noted by Keohane and Nye (1974) and then by European scholars with respect to European governance,[10] transgovernmental networks have become a modern alternative to formal treaty-making. Their current popularity reflects, according to Slaughter (2004: 8) citing Keohane (2001), the emergence in an ever more globalized world of the "governance dilemma," by which "we need more government on a global and regional scale, but we don't want the centralization..."

[7] See Vogel 2009: 160, and Bartley 2003.
[8] McNamara 1999, Ruggie 2004.
[9] Kirton and Trebilcock: 2004, 27.
[10] Among others, Dehousse 1997.

Among the usually-listed advantages of informality are low sovereignty costs, low negotiating costs, flexibility, less publicity, secrecy, and speed.[11] The degree of legitimacy of informal schemes is variable; in some cases, flexibility makes them more accountable to the parties with a direct stake in their existence;[12] in other cases, informality makes them more susceptible to corporate capture.[13] The main drawback is the lack of enforcement mechanism.

Based on these pluses and minuses, follows a list of univariate explanations for when states resort to informal agreements: technical expertise,[14] urgency,[15] short time-horizon,[16] harmonious preferences among a small group of members along with clubbiness and the deliberate exclusion of "spoilers" and free riders,[17] the presence of potential domestic veto players at home,[18] and uncertainty as to the other players' preferences or the future state of the world.[19]

Although endowed with analytical potential, these claims are still unsatisfactory, explaining too little on their own, not adding up to a coherent explanation together. In what follows, I propose a two-level approach to the topic of the origins of informal governance.

3 A two-level approach

All international regimes have at their root a cross-border externality. For instance, a traditional sector in the United States is lobbying for protection against imports from LDCs; Chinese steelmakers are asking their government

[11] See Lipson 1991, Abbott and Snidal 2000, Eilstrup-Sangiovanni 2009, Vabulas and Snidal 2011.

[12] Bernstein and Cashore 2004.

[13] Mattli and Woods 2009.

[14] Raustiala 2002-2003: 24, Whytock 2005: 30, Kerwer 2006,

[15] Raustiala 2002-2003: 6, Eilstrup-Sangiovanni 2009: 2006.

[16] Eilstrup-Sangiovanni 2009: 206.

[17] Raustiala 2002: 24, Whytock 2005: 20, Eilstrup-Sangiovanni 2009: 205, Kahler and Lake 2009: 273, Shaffer and Pollack 2010: 789.

[18] Eilstrup-Sangiovanni 2009: 209 and Kleine 2011.

[19] Lipson 1991: 518, Eilstrup-Sangiovanni 2009: 207, Shaffer and Pollack 2010: 789, Stone 2011, Vabulas and Snidal 2011.

to keep the yuan undervalued vis-a-vis the dollar; a factory is polluting the air that populations in neighboring countries breathe; a coal-fired power generator is emitting carbon dioxide contributing to the warming up of the planet; a logger is deforesting with no concern for the sustainability of tropical forests; a bank is taking excessive risk; a diamond wholesaler is buying "blood" diamonds from rebels and secessionist movements in West Africa; a German high-tech company is selling dual-use nuclear technology to Iran; a French physician is overprescribing antibiotics to his patients contributing to antibiotic resistance; and so on, and so forth.

While all regimes are a response to a cross-border externality, in many cases the cross-border externality is coupled with a domestic externality. For instance, the traditional sector in the United States and the steelmakers in China are also lobbying for a rise in the price of their products. Basically, protection hurts more than foreign exporters; it also hurts domestic consumers. The factory that is polluting the air in neighboring countries may also be polluting the air breathed by nationals living in the proximity. The planet is warming up for everyone, not just for foreigners; the same with rising nuclear risk. Before ruining the business of banking for foreign banks, the collapse of Lehman Brothers ruined it for American banks. The sustainability of tropical forests is a subject that mobilizes many people outside the tropics. More generally, global activism reflects the growing awareness that few issues have purely local effects. Global activism also reflects a broadening of the interpretation of the externalities as including "imagined" effects, for instance the vicarious discomfort felt at the thought of child labor in developing countries.

Of course, not all cross-border externalities have a domestic extension. The U.S.-Soviet rivalry during the Cold War had no domestic dimension, as each side was solidly unified both in fear and self-righteousness. I distinguish between the two situations by referring to the Janus-faced externalities as cases of "two-level externality" (featured in Figure 1) and the residual as cases of pure cross-border externality.[20]

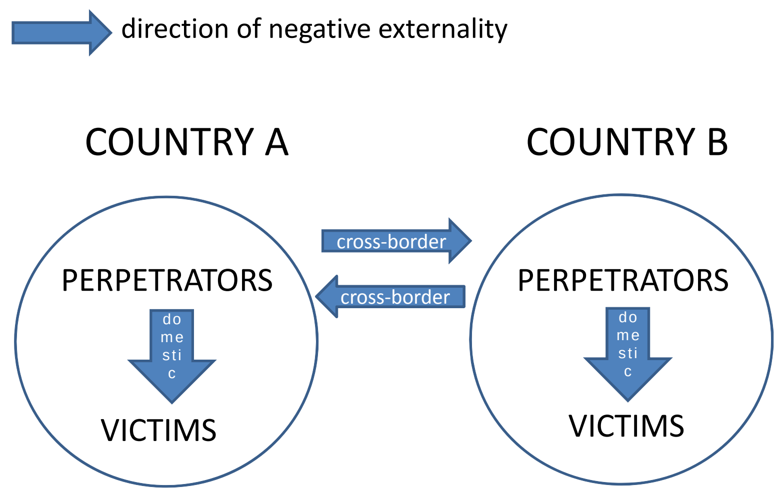


Figure 1: A Two-Level Externality Between Two Countries

A pure cross-border externality creates an international cleavage: it mobilizes domestic groups in one country against domestic groups in other countries. For instance, country A's exporters are mobilized against country B's protectionists and country B's exporters against country A's protectionists. A two-level externality not only creates an international cleavage on account of the cross-border externality, but it also creates a domestic cleavage: country A's consumers are mobilized against country A's protectionists and B's consumers against B's protectionists.

The international cleavage created by a pure cross-border externality does

[20] There are also cases where the externality is purely domestic. These are excluded from the present study, as they do not offer any potential for the creation of an international regime.

not imply that an international regime is not possible. Game theory teaches that two players caught in a repeated-PD game have the capacity to cooperate by setting up a sanctioning regime. It is just that the regime must be precise as to what constitutes instances of defection from cooperation and proper sanctioning. The same is true of our generic case of pure cross-border externality. In such a case, because the source of the harm is essentially external to the country, a government cannot expect to reduce the externality without a procedure that effectively binds other countries to curtail the harming activity, usually in exchange for mutual cooperation. Mutual cooperation in such a case has a distributive component making enforcement critical to the negotiations, as each partner to the international agreement has a vested interest in cheating on its promises. There is thus a need for a form of commitment that deters cheating. The best that international law can offer is a binding agreement with force of law and which, once signed, can only be rescinded after a time period or according to an official procedure more or less destined to invite retribution from foreign partners.

If domestic victims are also mobilized along with international victims, as such is the case in a two-level externality, then the need for a formal commitment is not as essential to the survival of cooperation. The pressure for curtailing one's damaging activity is not exclusively external, coming from the countries that are victimized by the cross-border externality, but is also internal, taking the form of a domestic constituency eager to terminate an activity, from which they suffer directly. This de facto "fifth column" plays the role of domestic anchor for the cooperative policy. Surely the government enjoys discretion over the setting of the policy, but it cannot stray too far from the domestic victims' ideal point without the latter mobilizing, lobbying, and thus bringing down the government's reservation value—the value for doing nothing—, in some cases to such a low point that the government may develop an interest in regulating on its own the activity responsible for the externalities, irrespective of what other governments are planning to do. International cooperation in such circumstances needs no formal commitment. There is no moral hazard to start with, as implementation is "self-enforcing", for enforced from the inside.[21]

The international debate may not be forgotten for all that. It may even be a desirable component of any compromise reached at home. It could be, for instance, that, in order to make regulation acceptable to domestic companies, the government seeks a simultaneous deal with foreign governments to extend similar regulation to these foreign governments' nationals in order to maintain a level playing field between domestic and foreign rival companies.[22] However, although the government may need an international deal in order to control the negative side-effects of unilaterally curbing the domestic externality, it remains that, absent that deal, the government will curb anyway—curbing is the dominant strategy.

If the two-level externality is evenly felt across a set of countries and causes a comparable alignment of domestic interest groups, it thereby creates the domestic basis in each country for going it alone. Together, they constitute a Schelling's k-group, with $1 \leq k < n$, that is, a core group of like-minded states that are willing to supply the "public good."[23] In the case where $k = 1$, we fall back on the well-known "benevolent hegemon" solution to the public good dilemma, except that hegemony, here, is not a reflection of power, but of a particular alignment of domestic interests, featuring an overmobilized coalition

[21] The argument dovetails Dai's (2007: chap. 4) "domestic constituency mechanism," according to which a country's degree of compliance with an international obligation is a positive function of the intensity of domestic activism. Yet our perspectives differ: while Dai argues that the formal treaty empowers the domestic constituency, I argue that the domestic constituency makes the treaty redundant.

[22] As in the case of the first Basle agreement: see Singer 2007.

[23] On *k-groups*, see Schelling 1978, pp. 220.

of domestic victims.[24] Therefore, the existence of "fifth columns" in the form of domestic coalitions favorable to the curbing of the activity-generating externality at home primarily and abroad secondarily makes cooperation possible, despite the absence of formal commitment.

I have so far argued that the mobilization of the domestic victims of a two-level externality makes treaty-writing unnecessary. I now argue that it makes it inefficient.

A purely cross-border externality has a unifying effect among domestic protagonists because the reason for the harm is essentially foreign. A two-level externality, in contrast, directly divides relevant groups into perpetrators, who benefit from the activity causing the externality, and their victims, seeking regulatory relief. In the presence of domestic division, the ratification of a treaty is a politically difficult act. In most democracies, ratification requires a qualified or an absolute majority of part or the whole legislature. In most cases, "gaining assent, according to Lipson (1991: 514), is time-consuming." Defeating opponents and overcoming blockroads require the proponents of the intergovernmental agreement to dominate the debate. And so, unless the proponents constitute an overwhelming majority capable of overcoming the opposition of veto groups in the bureaucracy, the legislature (the 2/3 Senate requirement in the U.S. Congress), and the electorate, the formal international commitment strategy is not a practical one.[25]

Besides making impractical the treaty route, domestic dissensus also makes the international debate ancillary to the domestic debate. An activity causing a two-level externality will enter the domestic debate before it surfaces in international negotiations. Hence, environmentalists would rather not wait for

[24] On benevolent hegemony, see Kindleberger 1973.

[25] I know, it is paradoxical that introducing a pro-cooperation coalition in a polity dominated by anti-cooperation elements may make the signing of a treaty more difficult. The truth is that it makes cooperation less difficult, but holding this constant, it makes it more difficult for this cooperation to take the form of a treaty rather than informal governance.

an international agreement for domestic firms to curb pollution. Nor would taxpayers prefer to wait for their regulators to reach an agreement with other national regulators in order to curb risk-taking in the domestic banking system. Domestic issues have greater political salience than international issues and the domestic side of the two-level externality is bound to prompt a debate and, possibly, law long before diplomats agree on a date and a venue.

The international debate is ancillary to the domestic debate in a second way, though the reason why this is the case varies with the way the issue is articulated at home— whether by politicians or by regulators. In the case where the issue is politically salient and constitutes an electoral stake between rival parties, it is important for a government of either partisan inclination to keep its options open and maintain enough flexibility. Policymakers must manage domestic support and opposition and strike delicate political deals. Maintaining flexibility on the domestic front makes a commitment on the international front problematic. A famous historical example was the frequent rewriting of the tariff legislation in the 19th century, with the rates being raised when protectionists were in power, lowered when free traders took over. Surely, the free traders would have liked to be able to take the debate out of the domestic context, where no form of commitment was ever achievable, to the international level, a realm where a government is able to lock in regulatory measures in the long term. But this option was not available in the absence of a supermajority in favor of the agreement.

The need for flexibility is less pressing in the case where the legislature has delegated the issue to a regulatory agency. By being under the exclusive jurisdiction of a regulator claiming expertise and, most likely, falling prey to capture by a selective number of concentrated interests, the policy dealing with the domestic externality may lose its immediate salience and gain some stability.

While the need for flexibility in the face of electoral uncertainty disappears, the agency that "owns" the issue is unlikely to risk sharing it with other institutional actors by pursuing the treaty route. A more effective turf-protecting strategy is to engage in a private debate with equivalent foreign agencies. The upshot is a transgovernmental network, one that is likely to be "captured" by corporate interests.[26] The larger point is that, whether the management of the domestic externality is front and center or relegated to the backoffice, the upshot is a domestic policymaker that is unwilling to make a formal intergovernmental commitment. In the presence of a two-level externality and absent a supermajority, therefore, treaty making is both impractical and inadvisable.

I have so far advanced two general claims. First, unlike a pure cross-border externality, a two-level externality generates a fifth-column of individuals willing to side against the domestic perpetrators of the externality and, thus, on the side of the foreign governments. Second, I have argued that in such circumstances, the resulting international regime is more likely to be a case of informal governance than of hard law. These two arguments together make a case for sufficiency—a two-level externality is sufficient ground for creating informal governance—but not for necessity. Yet, necessity is right around the corner. It is difficult to imagine how informal cooperation could emerge without being deeply anchored in the domestic fabric of each member government—appropriately called by the literature "like-minded" governments. Because it relies on stated intentions rather than legal commitments, informal governance, whenever left to itself, is rife with moral hazard, the solution to which almost always is the introduction of formal guidelines either in the form of customary behavior in waiting for codification, precedents awaiting extrapolation, and routines on the way to becoming norms. There is no purely informal solution to the

[26] Mattli and Woods 2006 and contributions by Kahler and Lake. Eilstrup-Sangiovanni 2009.

kind of moral hazard that originates in non-committal promises.[27] Therefore, for informal governance to be sustainable, moral hazard has to be absent from the outset, and the only way this can be informally is by having a dominant strategy of cooperation, something that is made possible by the existence of a domestic player capable of vetoing defection. Surely, a dominant strategy of cooperation does not make for a strong bargaining posture when engaged in interstate bargaining, but the point about informal governance is that, unlike treaty making, it does not, and cannot, rest on interstate bargaining to begin with.

Finally, there is one last question that needs to be tackled before looking at the case studies: Under what circumstances the externality will be of the pure cross-border or the two-level type? A popular answer in the current informal governance literature is "globalization."[28] There are two plausible grounds for it to be true. On the one hand, globalization increases the pro-cooperation coalition, thereby removing the need for a formal agreement. The purpose of an international regime, indeed, is for countries to cooperate to produce a collective good. The greater the percentage of individuals in one country who consume this public good, the larger the constituencies whose utility, material or imagined, would be directly threatened by an activity curbing that public good. Consider the case of currency stability to be further developed below. Trade and investment are hurt by currency instability. The more developed trade and investment are, the larger the number of individuals in each country whose income is negatively affected when their government engage in currency manipulation of any sort.[29] As the ratio of trade to world output increases, therefore, currency instability moves from being a pure cross-border negative externality, with limited direct domestic impact, to being a two-level negative

[27] For a potentially different view, see Kleine 2011.
[28] See note 6.
[29] Frieden 1994.

externality, with a broad and significant domestic impact.

On the other hand, globalization also raises domestic uncertainty, thereby creating a need for policy flexibility.[30] Globalization exposes economies to a larger number of unpredictable shocks—rise in commodity prices, banking crash, currency or bond crisis. So, even though the growing strength of the domestic anchor points to a long-term trend favorable to cooperation, short-term deviations from the trend may at the same time grow wider and less predictable, forcing some countries to momentarily reassess the extent of their international cooperation. While this flexibility could be had through formal means, such as finite-duration contracting, escape clause, or various safeguards, it can be had at lower costs through informal governance.[31]

In sum, given a cross-border externality, the government has a choice between internalizing it through an international treaty or through domestic legislation. Untangling the causal chain into three consecutive steps (Figure 2), the first step derives the type of externality from the degree of globalization:

Claim 1 *The more globalized a public good, the more two-level-like is the externality caused by an activity negatively affecting the supply of the public good.*

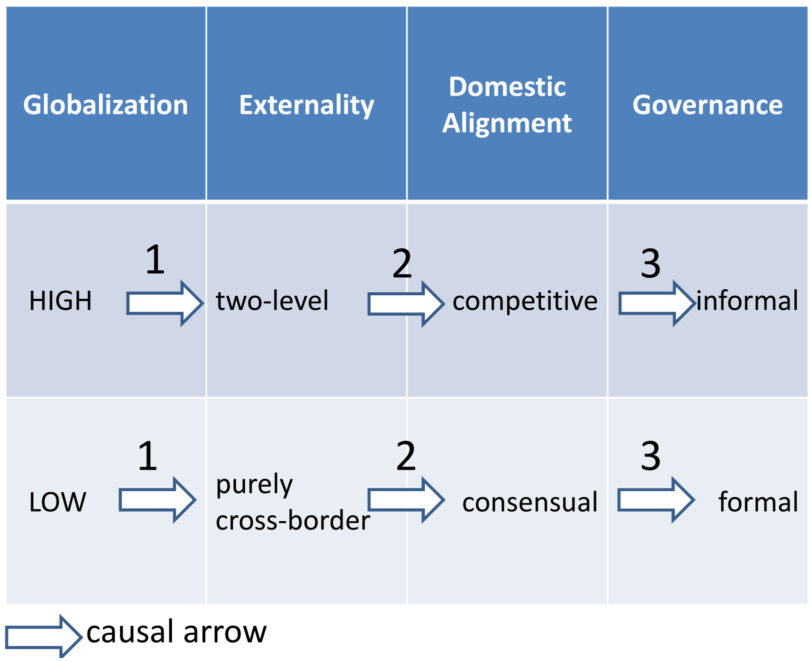
Then comes the link between the type of externality and domestic alignments:

Claim 2 *A pure cross-border externality is associated with a domestic consensus among victims of the cross-border externality behind the preference for a treaty. A two-level externality generates dissensus: a fifth-column of victims of the domestic externality want their government to regulate the domestic perpetrators of the externality by means of domestic legislation.*

[30] See Downs and Rocke 1995: chap. 4 and Rosendorf and Milner 2001, Koremenos 2005.

[31] For an argument linking domestic uncertainty to the need for informal governance, see Kleine 2011.

Figure 2: Claims 1, 2, and 3



Last, the move from domestic alignment to regime format:

Claim 3 *In the presence of consensus, the government prefers a treaty-based regime. Absent consensus, the government's actual preference is for domestic action accompanied with some form of coordination with foreign governments through an informal regime.*

The claims call for clarifications. First, the failure of the formal route will not always mean the success of the informal route, no more than the failure of the informal route will always imply the success of the formal one. Quite often, cross-border externalities do not lend themselves to the creation of a regime of any kind because the relevant countries find themselves too far apart in their preferences.[32]

Second, if two countries seek to establish a regime, but one prefers the informal route whereas the other prefers the formal route, holding everything else constant, it is likely that the informal route will prevail, as it is preferred to a no-regime outcome by the country advocating the formal route.

Third, the claims presume democracy and limited collective action problems. They fail to hold in autocracy, where the ruler's unchecked control over policy-making gives him or her an automatic supermajority and thus the capacity, if he or she so desires, to pursue a formal agreement. Furthermore, the autocrat's absolute power makes treaty-making desirable, for, in the absence of a "domestic audience," it is the only available way of establishing policy credibility.[33]

Claim 4 *Autocratic governments are more likely than democratic governments to prefer treaty making to informal networking.*

4 The particular case of private governance

The argument so far deployed involves the action of governments. It is a better description of the conditions for the creation of transgovernmental networks than for the creation of private governance, where government action is typically absent or limited to facilitating monitoring and enforcing compliance. Yet, except for one significant variation, the constitutive scenario is pretty much the same.

Private governance presents the same symptoms as transgovernmental networks: there is a cross-border externality that has a domestic component and thus divides society between two opposing factions, one seeking to regulate the activity generating the externality and the other resisting that move. The main

[32] For a good example of this, see Pollack and Shaffer 2009 on genetically modified organisms.
[33] See Pevehouse 2003.

difference lays in the fact that both sides in the debate, the victims of the externality (mobilized by NGOs) and the industry responsible for producing the externality, find it in their mutual interest to keep the debate and the solution to the conflict out of politics and government intervention—norm-setting is contractual and compliance with the norm voluntary.

On the victims' side, first, short of a health or environmental catastrophe that mobilizes voters, it is just difficult to get access to policymaking. As Vogel (2009: 160) argues, governments have been unwilling or unable to regulate TNCs' activities in developing countries, facing staunch opposition from these companies at home and lack of support from LDC governments abroad. An important reason for governmental inaction, according to Vogel (2009: 167), is the fact that the use of trade sanctions against "irresponsible" labor and environmental practices and countries with poor records on human rights is illegal under the GATT/WTO treaty. In contrast, private eco-labels, certification schemes, and codes of conduct as long as they are private and not formally adopted by governments, are legal. Faced with government inaction, NGOs have fallen back on using shareholder activism and litigation in concert with media attention, boycotts, and protests against the goods, brands, and services that TNCs retail in developed countries.

Private governance is better than transgovernmental networking at staying clear from the WTO; it is also better at dealing with public goods. For instance, a unilateral government policy requiring domestic foresters to show concern for sustainability makes domestic producers less competitive than foreign producers and causes consumption to shift from domestic to foreign producers. In contrast, the threat of a consumer boycott of wood products put on the market by such foresters treats domestic and foreign producers alike—there is no substitution effect. A consumer boycott is a classic case of market exclusion, transforming a non-excludable public good into an excludable club good. No similar government-mandated exclusion is legal for goods covered under the WTO. These advantages, of course, come with strict conditions of application: a boycott is not effective unless there is a consumer product, an identifiable producer or brand, and a mediatic victim (dolphins, turtles, puppy seals, pelicans, babies, indigenous populations), making private governance impractical in fields such as banking, missile and nuclear technology, or carbon dioxide emissions. Last, boycotts are not sustainable.

Next, on the side of the "corporations at risk," as Mattli and Woods (2009: 33) aptly call them, these corporations have an interest in responding to threats of boycott by agreeing to endorse some of the NGOs' demands in the form of direct, contractual deals. The alternative to private arrangements, which would be to mobilize pro-business politicians in the government or the opposition, could potentially be worse, as it would invariably open the debate to a multiplicity of tangential societal and bureaucratic interests, likely to add to the regulatory burden. There is also the risk that a debate on business practices in developing markets would arouse a humanitarian and nationalist reaction against third world governments which would only hurt trade with these countries and thus trade between the TNC and its own subsidiaries.

Hence, two cases should be distinguished. In one case, the corporations that are responsible for the externality have their production facilities at home; they fear for their competitiveness and invite their government to enter into negotiations with foreign counterparts in order to harmonize national regulatory regimes. We are back to the scenario of the transgovernmental network presented above.

In the other case, the private governance case, the corporations responsible for the externality are true TNCs, with substantial presence both at home and abroad. For them, having governments hatch a deal, whether governmental or transgovernmental, so as to make it harder on foreign companies to rival with domestic companies would merely target their own subsidiaries or their outsourcing partners. TNCs are better off taking up the negotiations directly with their domestic opponents into their hands, free of government interference.

Hence our last claim:

Claim 5 *Given that a government prefers an informal regime, this preference goes for private governance if the regime targets TNCs, but for transgovernmental networking if it targets national corporations.*

5 Currency

A desirable currency regime is one in which currencies are stable enough in relation to one another so as not to hinder the flows of goods and capital across national borders. Stability is difficult to realize in the presence of fundamental imbalances between countries, when some countries spend and consume too much while others spend and consume too little. Imbalances cause chronic current account surpluses and deficits that call for regular currency realignments, which, on aggregate, are detrimental to trade and foreign investment.

Besides contributing to global instability, any currency manipulation—whether to strengthen the currency through deflation to amass a war chest or to lower borrowing costs, or the converse weakening of the currency through devaluation and exchange controls, usually to increase the proceeds of seigniorage or promote domestic industry—has an immediate impact on other countries' trade or payment position. That impact is usually negative, as countries can rarely hope to improve their lot without imposing costs on their trade and financial partners.

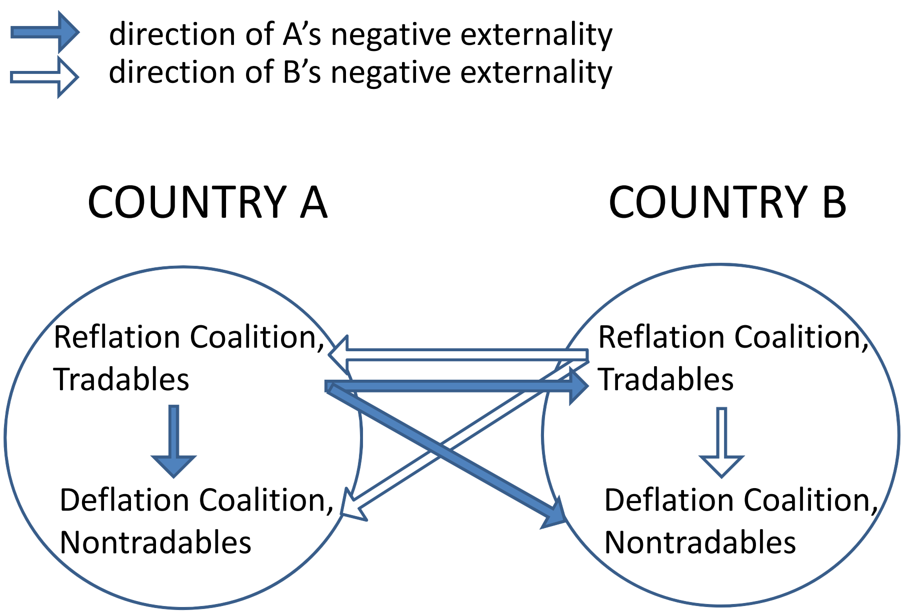
Currency policy and its monetary and financial extensions also have domestic externalities. The value of a currency, its current and expected strength, are generally subject to debate among various domestic holders. The dividing line typically falls between those who think the currency to be too strong and those who think it to be too weak. Historically, that debate pitted monarchs seeking to debase the currency, usually in order to fight dynastic wars, against wealthy merchants and bankers concerned about the value of their holdings denominated in that currency.[34] Since the 19th century, the debate has divided producer groups. Among those who would typically support a strong currency along with its deflationary discipline are fixed-income earners such as rentiers, bondholders and, more generally, creditors and banks (the deflation coalition). In contrast, groups that would normally oppose deflation include variable-income earners (workers, stockholders), whose income suffers from economic downturns, and debtors (farmers, business), who value easy credit (the reflation coalition).[35] Intersecting the deflation-reflation divide is the purchasing power-competitiveness divide, pitting tradables, who support a low, though stable, currency, against non-tradables, who prefer a strong currency.[36]

Bankers are rarely united, however, as a third type of cleavage comes into play in matters of currency manipulation: financial regulation. Financial regulation is an issue that usually cuts between large commercial banks, who welcome competition, and smaller, local banks, who need regulation and state support to survive or even exist in the first place.[37] Deregulation is correlated with globalization and the pursuit of a strong currency, regulation with closure and a weak currency; large banks typically belong to the deflation coalition, while local banks belong to the reflation coalition.

[34] North and Weingast 1989.
[35] Simmons 1994.
[36] Frieden 1991, 1994.
[37] Verdier 2002.

I draw in Figure 3 the negative externalities associated with currency manipulations favorable to the reflation coalition and tradables. Country A, say, initiates a devaluation of the currency, forcing Country B to do the same as in a one-shot game of PD. The externalities of each move negatively affect all foreign producers and some domestic producers (creditors, fixed-income, banks, and non-tradables).

Figure 3: Negative externalities generated by currency manipulation favorable to the reflation coalition and tradables



Looking at Figure 3, there are two ways that governments can hope to sustain a regime of exchange rate stability: (1) informally, if bankers, creditors, and non-tradables are strong enough together to oppose currency manipulation, inflation, and banking regulation; or, if the domestic route is not available, (2) intergovernmentally, through a legal commitment. The availability of the domestic route has tended to vary over the century with the degree of trade and investment interdependence (claim 1). As Frieden (1994: 84) argued, "as more goods become tradable, more producers are more concerned about currency values."[38] More tradables grow more dependent on cheap imports to stay competitive both in domestic and export markets. While a weak currency might increase the competitiveness of their final product, this positive effect is cancelled by the greater cost of inputs that enter into the production of the final product. Hence, as more producers in the economy become exposed to currency risk, the coalition favoring stability is bound to gain ground, hold its own against the coalition favoring manipulation, and veto currency manipulation.

Trade and investment interdependence grew faster than economic output in the 19th century, then slower during the interwar, and faster again after World War II (see Figures 4 and 5).[39] From this, one predicts that groups favoring currency stability should have become more assertive before 1914, should have declined between the wars, and grown assertive again after World War II (claim 2). This periodization in turn allows me to explain, although with a twenty-year lag, the timing of regime formality: the currency regime was informal until the 1930s, became formal in the 1940s, and reverted to informal in the 1970s (claim 3).

5.1 The Gold Standard

The gold standard regime was a case of informal governance of the transgovernmental network type. I show that such informality rested on the inability of most governments to decisively choose between selling and purchasing silver during the first thirty years. Silver negatively affected creditors, who opposed debtors on the issue of silver purchases and advocated informal coordination

[38] For cross-country evidence, see Frieden and Stein 2001: 10.
[39] See also Irwin 1995.

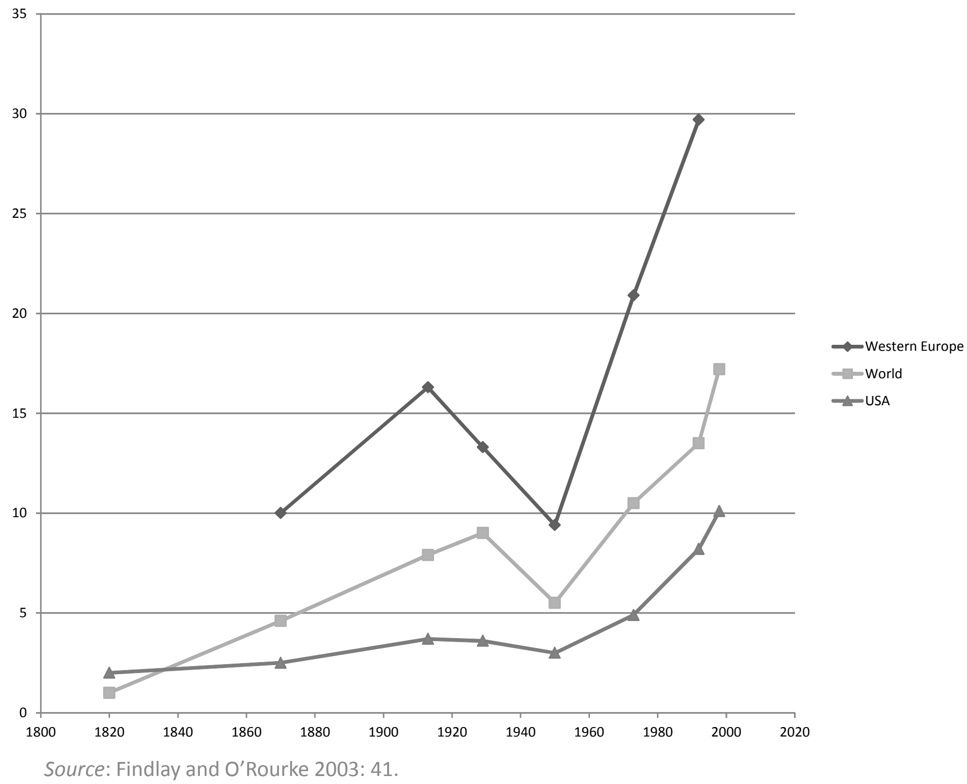


Figure 4: Merchandise Exports as a Share of GDP (%)

around gold.

The gold standard was a world-wide fixed exchange rate system by which each member sought to maintain price and currency stability. The Gold Standard was a regime in the sense that it required countries to follow specific rules of behavior. To be considered on gold, a government had to announce a gold price for its currency and subsequently agree to transact that currency for gold at that announced price with any individual or bank wanting to buy or sell that currency. Each currency was not perfectly fixed, but allowed to float within the bounds defined by the so-called "gold points"—the cost of shipping gold be-

Source: Obtsfeld and Taylor 2003: 141.
Note: "Assets" are total nominal foreign investments in all countries. "World GDP" is total output in all countries, including countries for which there are no foreign investment stock data—the resulting ratio underestimates (is a lower bound of) the true ratio of foreign assets to output. "Sample GDP" is total GDP in the U.K., France, Germany, the Netherlands, the U.S., Canada, and Japan until 1980 and up to thirty countries with foreign investment afterward—the resulting ratio overestimates (is an upper bound of) the true ratio. The true ratio falls between the upper and lower bounds.

Figure 5: Foreign Capital Stocks as a Share of GDP (%)

tween countries and thus variable with distance: $\pm\frac{1}{4}\%$ in Europe, $\pm\frac{1}{2}\%$ across the Atlantic.

That regime, however, was informal. By 1867, there was a consensus among major economic powers that the gold standard was desirable. Yet, the gold standard was not without its shortcomings, but caused worldwide deflation, with producers in each country more or less internally divided along the fixed-variable income and tradable-nontradable lines of cleavage. Several conferences, all informal, were convened to discuss measures to tackle these problems. In each instance, delegates were diversely drawn from each country's local legation, central bank directors, and experts on the currency question having in the past occupied positions of authority in their respective country, but none of them had the power to commit their government. The goal was for each delegate to sound out the intentions of other governments with respect to the coinage of gold in 1867 and that of silver afterward and report them to their respective governments. They were the 19th-century equivalent of today's G-20 meetings of finance ministers and central bank governors.

At the 1867 Paris conference, delegates from 20 countries discussed international monetary unification.[40] Gold sudden abundance, following discoveries in California and Australia, made it thinkable to retire silver and move to the more desirable gold standard, at least for international transactions.[41] The explicit goal of the conference, which was to debate a French proposal to unify gold coinage around the French 5-franc gold coin in exchange for France abandoning the coinage of silver, failed and the participants, instead, walked away with two broad "understandings"—the desirability of a gold standard and of the decimal system—, which, by the time of the Franco-Prussian war, were not implemented, because of the opposition, among others, of the French Treasury and the Bank of France, two staunch supporters of bimetallism.[42] It is only after the war that Germany, emulated by the Scandinavian countries first, and Belgium and Switzerland then, suspended the coinage of silver. As these countries proceeded to unload their demonetized silver on the market in exchange for gold, they forced the Bank of France—until then the linchpin of bimetallism—to suspend its coinage and sales of silver.[43] The scramble for gold got worse in 1888 because of the move on gold by Austria, Rumania, and Russia.[44]

The demonetization of silver along with the Nevada silver strikes initiated a

[40] Einaudi 2000: 291.
[41] Russell 1898: 200.
[42] Einaudi 2000: 292.
[43] Gallarotti 1995.
[44] Russell 1898: 359.

long-term decline in the value of silver that hampered the transition to the gold standard for the next thirty years. The move to the gold standard became an issue that divided societies along the above-mentioned lines, made gold scarce, leading central banks to scramble for gold by raising their discount rates, slowing down the world economy and causing a price deflation that hurt landowners with fixed mortgages. The concomitant depreciation of silver in relation to gold caused difficulties for countries who kept silver as their sole monetary standard, India, China, and Latin America, and saw their capacity to repay foreign loans and attract foreign capital diminished. It also caused difficulties for European and American trade with these countries, especially the Lancashire mills, whose exports were displaced by more competitive Indian cotton manufactures, not just in India but also in the rest of Asia.[45] German Junkers' exports of grains were also displaced from Eastern European and Russian markets, operating on paper money, and de facto silver. Furthermore, the depreciation of silver hurt the Bank of France, on account of the silver entry on the balance sheet, larger than its capital; it hurt the Reischbank because of the massive losses incurred on each sale of silver mandated by the conversion to gold; and it hurt all other countries for similar difficulties in acquiring gold. Yet, all countries preferred gold to silver, thereby making silver purchases a public good: every country would have liked to see something being done about it, but by someone else.[46] And the U.S. government, on account of periodic Congressional debates on silver coinage bills, seemed to be the right candidate for going it alone.[47]

All three conferences on the remonetization of silver—the 1878 and 1881 Paris conferences, and the 1892 Brussels conference—were called, indeed, by the U.S. government, the most embattled at home on the silver issue. The victims of the move to gold, U.S. farming interests, along with Western silver

[45] Russell 1898: 361.
[46] In game theoretic terms, it was a classic game of chicken.
[47] Russell 1898: 225.

miners and Midwestern manufacturers, supported the remonetization of silver to keep domestic prices up. The issue was constantly debated in Congress; the 1896 election was fought on the gold standard. Out of the saliency of this recurring domestic debate came out the 1878 Bland Allison Act providing for limited silver coinage and asking the government to convene a conference to the effect of convincing other governments to emulate the United States—a move typical of informal governance of the transgovernmental-network type.

As a result, all other members were in expectancy. At the 1878 conference, for instance, most delegates, following the English delegate, declared being interested in the discussion but incapable of making any commitment that would be binding on their governments; Germany did not even send a delegate.[48] In 1881 and 1892, Germany did send a delegate, but one that, like the British delegate, was non-committal. Between conferences, back home, each government passed measures to alleviate the silver glut that it saw fit unilaterally and for domestic reasons. Germany suspended sales of silver in 1879 and Bismarck recommended the substitution of silver money for small gold coins; Britain kept the Indian mint open to silver. Throughout the 1880s, the central banks of England and France launched policies of gold accumulation at all costs, Germany raised its tariffs to reduce imports and, in a much mercantilist fashion, to draw more gold from abroad, while Russia in 1889 began to amass a war chest of gold.[49] Meanwhile, Britain convened a commission, which split in half between bimetallists and gold monometallists, and the United States and India kept coining silver until 1893, when they finally suspended all purchases, sending the price of silver into free fall. Following the defeat of the silver democrats in the 1896 election, Britain, France, and the United States one last time explored the possibility of still another monetary conference, in vain, this time, on account of the Indian

[48] Russell 1898: 244.
[49] Russell 1898: 334, 422.

reluctance to reopen its mint to silver.

New gold strikes in 1894 reversed the trend and, by the turn of the century, the silver issue went away. The regime, from then on, was essentially operated, on the public side, by central bankers and treasuries, who were in charge of keeping the parity, and, on the private side, by world-known private bankers, dictating conditions that borrowing treasuries had to meet in order to float their loans in the capital-rich markets of the day. From 1900 on, the only cooperation left was between central banks, all private institutions, coordinating their interventions and lending gold to each other in times of crisis.[50]

A reason for the failure of the conferences on the coinage of silver was the uneven distribution of pro-silver coalitions across countries. The United States was the most affected polity, leading Washington for fifteen years to unilaterally purchase silver, with the effect of keeping it from depreciating too much and, thereby, allowing other countries to do nothing of sort. Had the United States not adopted the Bland-Allison bill, Russell argued (1898: 198), Britain and all other Europeans would have been forced to buy silver.

Yet, even had the conferences succeeded in bringing the countries to convergent positions, the informal nature of the gold standard would have remained unaltered. While the main protagonists wanted the price of silver to stabilize, they were unwilling to commit to any measure that would have forced them to intervene in the silver market at a moment they might have deemed inauspicious. Their averseness had less to do with the nature of the silver issue per se than with the contested nature of the standard in each country, leading most governments to leave the adjudication of the issue to "the market," that is, central bankers bent on maximizing gold holdings—the United States was an exception. It is no surprise, therefore, that until 1914 the gold standard relied on strict and constraining legal instruments, but these instruments took the form of national

[50] See Kindleberger 1993: 66. Eichengreen 1992: 31.

statutes and central bank charters—no hard international agreement was ever negotiated or signed. The regime was a classic case of informal governance with a weak transgovernmental dimension on account of the public good character of silver purchases.

It is well-known that the gold standard did not work smoothly for all participants, but only for those that were able to float their debts in their own currency. There were eight of them: the U.K., France, Germany, the Netherlands, Belgium, Denmark, Switzerland, and the United States. All others were forced to issue bonds with a repayment option in gold or denominated in the currencies of capital-rich countries. These other countries were characterized by what economists call "financial immaturity," that is, a weak domestic demand for the currency, usually having its roots in misguided monetary and fiscal policies.[51] Weak domestic demand for the national currency denied a government the capacity to stay on gold, if at all, without having to maintain close to 100 percent gold reserves and/or debilitatingly-high interest rates. Weak demand reflected the absence of a domestic anchor in the form of a powerful constituency of bondholders capable of blocking monetary and spending measures that would have undermined the gold value of their nominal income.

5.2 Interwar finance

World War I put an end to the gold standard regime as it had existed until then as a transgovernmental regime. The financial instability wrought by the war led many countries to believe that it would take an intergovernmental agreement to restore prewar stability. No such agreement could be reached, however, leaving the informal currency regime teetering on the brink of collapse until deflation coalitions were so weakened by the Great Depression and the ensuing war that the international monetary system had to be entirely rebuilt from the top down.

[51] Bordo and Flandreau 2003: 439.

The preference for a treaty-based regime at first stemmed from the linkage of the currency with the reparation issue. The victors at Versailles had slapped debts and reparations on the vanquished, while, among the victors, the battlefield countries of Europe were bound to repay the war loans to the United States. These sums were large enough to intrude on any calculations regarding financial stabilization. As the early tribulations of the German economy kept the issue open, it could only be dealt in the context of a multilateral conference.

Two conferences were organized, in Brussels in 1920 and Genoa in 1922, to no avail, the United States being unwilling to discuss either issue in a multilateral venue. The solution was left to time and a series of currency crises which, eventually, led most countries to devalue their currency in relation to gold. The gold standard was then resumed in 1928 as an informal regime of the transgovernmental network kind very similar to what had existed before the war, with central bankers coordinating monetary policies on a bilateral basis and within the multilateral context of the Bank of International Settlements, created in 1930 to help manage war payments.

The newly-restored gold standard, however, was short-lived, as Britain took its currency off gold in 1931, the United States in 1933, and France in 1936. The source of the problem was asymmetric adjustment between surplus and deficit countries, a problem rendered more acute by the transformations wrought by the war. World War I introduced the option of systematic sterilization. In the wake of the conflict, public debt inundated capital markets, forcing central banks to make the market for such securities, and thus hold large amounts of them. As a result, a surplus of foreign exchange no longer had to be monetized, but could be moped up by selling government securities. A deficit, however, could not be sterilized, except, perhaps, in the short term, without depleting foreign reserves and triggering a run on the currency.

Following the war, moreover, the issue of monetary adjustment was politicized in all countries. Organized labor emerged as a political force, able to put pressure on government to block deflation and undermining the position of the stable-money coalition.[52] Deficit countries could even less afford deflation to correct a current account disequilibrium than they did before. Long-term imbalances emerged between countries developing chronic surpluses and those developing chronic deficits, as the former and the latter refused to inflate and deflate respectively, eventually making the position of deficit countries unsustainable and subject to catastrophic corrections.

With deflation no longer politically sustainable in deficit countries, their governments began to look for alternatives in the form of trade protection (developed below) and currency devaluation. Devaluation gave a government the space to reflate its economy and, in the short run, enjoy a reprieve from a trade deficit. For instance, France, after a decade of political and financial instability, rejoined the gold standard in 1926 at one-fifth the franc's prewar parity and began enjoying rapid economic growth and chronic trade surpluses with her neighbors. But devaluation in one country took place at the expense of its trade partners, in turn forcing a devaluation of the currencies among trade partners or, as currency instability made tariffs ineffective, more protection.

It has been said time after time that devaluation transformed the gold standard into a prisoners' dilemma game of the "beggar-thy-neighbor" type. This did not necessarily mean that governments were locked into the suboptimal outcome.[53] What it meant, though, is that the forced devaluation of a key currency might trigger a chain reaction among other currencies, because the stable-money coalitions of the 19th century could no longer offset the overwhelming power of organized labor, debtors, and tradables together—only an

[52] Simmons 1994.
[53] Eichengreen 1992: 172-183.

international agreement could. Hence, when the French franc, eventually, came off the gold standard in 1936, the new franc rate was negotiated by French Finance Minister Auriol with his equivalents in London and Washington with the aim of staunching the domino effect. The so-called "Tripartite Agreement" was not a treaty proper, but three statements of intention issued separately and void of any binding force, in which the three countries affirmed their desire to cooperate in minimizing exchange rate instability and invited the cooperation of the other countries. France, Britain, and the United States, it read, "trust that no country will attempt to obtain an unreasonable competitive exchange advantage and thereby hamper the effort to restore more stable economic relations."[54] It was a notch above the informal cooperation that central banks had engaged in until then, but still a step below the formal treaty that would be signed at Bretton Woods.

5.3 Bretton Woods

World War II further propelled the move already initiated in the 1920s toward a treaty-based currency regime. The domestic basis for this change was the economic and political weakening in all countries, including in the two main protagonists Britain and the United States, of private and international bankers—only an international treaty could resume exchange rate stability.

The postwar negotiations for the restoration of trade and financial stability involved two countries, Britain and the United States, which assumed polar opposite positions on the surplus-deficit divide. The United States walked out of the war with a booming economy and an expected current-account surplus, whereas Britain contemplated years of deficit. Their interests in reconstructing the world financial architecture were reverse: Washington saw an expansion in international trade as essential to the attainment of full employment in the

[54] Bank of International Settlement 1937.

United States, whereas London saw full employment at home as a precondition to the expansion of trade—Britain was ready to reject any currency discipline that would hinder its capacity to reflate its economy.[55] The United States wanted to abolish quotas, discrimination, and exchange control, while Britain wanted to keep them in case they were needed to save monetary reserves.

The gold standard had lost its domestic footing in Britain. Industrial workers were the largest electoral force and Labour came out of the war as the dominant party. Groups with a vested interest in a strong currency could no longer be counted on to prevail over workers to keep the domestic currency strong. The City was weakened by stringent regulations at home and decades of capital controls around the world.

The gold standard still had plenty of supporters in the United States, but not in the market format as it had existed until 1933. The New Deal planners were not believers in *laisser faire*, but held that government had an important role to play in the successful management of the economy. Treasury Secretary Morgenthau wanted, in his own words, "to move that financial center of the world from London and Wall Street to the United States Treasury..." He wanted to erect new institutions which would be "instrumentalities of sovereign governments and not of private financial interests"... "to drive the usurious lenders from the temple of international finance."[56]

Bank failures and the Glass-Steagall Act considerably weakened New York bankers, who between 1945 and 1962 lost 22 percent of all existing bank assets mostly to local, nonprofit banks (Mutual savings banks and Savings and Loans).[57] In every country, regulatory strictures brought the large commercial banks down. Most countries separated deposit taking from securities underwriting. Commercial banks in Britain, France, Germany, and Italy were discour-

[55] Gardner 1969: 274.
[56] Quoted in Gardner 1969: 76.
[57] Verdier 2002: 248.

aged from opening new branches. Commercial banks could no longer engage in mortgage and other types of medium- and long-term lending. Everywhere the large commercial banks lost to their nonprofit competitors where those still existed, while where those did not anymore, as in France, Belgium, Italy, the Netherlands, and Greece, small business and farmers were given their own, state-guaranteed credit banks.[58]

Financial stability no longer was a domestic affair, but became an international issue, as the two governments rejected the adjustment problem on each other's shoulders. As a deficit country, Britain, saw the source of financial disequilibrium in surplus countries' mercantilist policies of gold accumulation. Britain would not be able to maintain full-employment if surplus countries were not inflating in sync with Britain. In contrast, the United States, a surplus country, attributed monetary instability to governments that were incapable of balancing their budgets. The United States would not be able to lower its import tariffs unless deficit countries were able to stabilize their currency. Finance became an issue of international bargaining pure and simple.

The negotiations of the Bretton Woods Charter were an Anglo-Saxon give-and-take. Although both delegations agreed from the outset to the creation of a Fund that would lend liquidity to needy members, the British negotiators, led by Keynes, wanted a Fund endowed with large resources and whose role was that of a rubber-stamp. Their American counterparts, led by White, instead wanted a smaller Fund with the power to require changes in the domestic policies of its members. Similarly, both sides agreed to each member's right to use exchange control and devaluation in case of currency misalignment, but the British wanted the right to be unqualified whereas the Americans wanted it only to correct a "fundamental disequilibrium" and given with the Fund's explicit concurrence. Finally, the British wanted the burden of adjustment to fall on the

[58] Verdier 2002: 129-133.

surplus country's shoulders, whereas the Americans wanted it to be the deficit country's responsibility. The final text was a series of compromises on each point of contention.[59]

The Charter, despite its formalism, included clauses giving member governments enough flexibility to enable them to pursue full-employment policies in the face of current account constraints; they could borrow from the IMF and even devalue within limits detailed in the document.[60] Governments had, of course, informally enjoyed that same flexibility under the gold standard, although few of them had ever availed themselves of it beyond the narrow band defined by the gold points. It is just that the delicate balance between flexibility and credibility had, by then, shifted by 180 degrees: credible under the gold standard, informal commitments to currency stability were no longer so in 1944. Absent a domestic anchor in the form of a deflation coalition, governments had to piece stability together by surrounding flexibility with a series of formal conditions.

It is symptomatic that New York Bankers opposed ratification, whereas the Independent Bankers Association, representing 2000 banks in the rest of the United States, supported it.[61] Among the various reasons why New York bankers rejected the Charter was the scarce currency clause, providing deficit countries with a source of pressure on a surplus country. The clause stipulated that if a currency became scarce in the Fund (threatening the Fund's ability to supply that currency), the Fund should declare it scarce and apportion its supply by allowing other members to introduce exchange restrictions against that currency. In other words, if the United States were to pursue a monetary policy that was deflationary relative to the rest of the world, deepening the U.S. chronic trade surplus and increasing the demand for the dollar, deficit countries could penalize U.S. trade, thus compelling Washington to expand its economy

[59] See Gardner 1969: 112-21.
[60] See Ruggie 1992.
[61] Van Dormael 1978: 241, 257.

and absorb more imports.

The clause was never invoked, not because it was irrelevant, but because throughout most of the period when the dollar was a scarce currency, Bretton Woods was suspended and replaced by a system of clearing agreements, the European Payments Union (EPU), conceived in the same spirit as the scarce currency clause. European countries discriminated against U.S. goods to save dollars, while the United States was trying to supply Europe with as many dollars as it could through the Marshall Plan.[62]

In sum, the Bretton Woods agreement was the fact of countries in which groups favoring currency manipulation to pursue concerns of a domestic nature such as reflation or industrial competitiveness dominated the scene on both sides of the Atlantic.[63]

5.4 The end of Bretton Woods

President Nixon suspended the convertibility of the dollar into gold at the $35 per ounce parity in 1971. Yet, rather than agreeing on a new parity along with a few fixes, the member countries decided to wait and see, eventually ushering in a regime of floating exchange rates. This new regime is best described as a transgovernmental network, as key countries have been coordinating their monetary policies erratically at the summit level (the various G-groups) and harmonizing their regulatory policies more systematically at lower decision levels by means of not-legally binding agreements (the Basle accords).[64] The Fund is still signing binding agreements with debtor governments, but this task is mostly circumscribed to the economies of the financial periphery. Why did the parties to the Bretton Woods agreement not return to setting fixed par values

[62] Kaplan, Jacob J. and Günther Schleiminger 1989.

[63] Ruggie (1992) coined the expression "embedded liberalism" to characterize this historical situation.

[64] Webb 1991; Raustiala 2002: 28-35; Speyer 2006; Kerwer 2006; Singer 2007; Mosley 2009; Helleiner, Pagliari, and Zimmermann 2010.

in the 1970s and 1980s?

My answer is that they did not need to revert to fixed parities to stabilize international finance. In contrast to its dismal history during the interwar period, the regime of floating exchange rates on average proved to be remarkably stable, at least among core currencies. The only real exception was the steep rise and fall of the dollar under the Reagan administration. Currency instability has, so far, been relegated to the periphery—Latin America and South East Asia.

The causes for this relative stability are to be found, I argue, in two interconnected changes that occurred at the international and domestic levels respectively. At the international level the Fund's lending capability became redundant. The development of an international money market in the form of the Eurodollar market at first and involving all major currencies afterward made the Fund's resources redundant for all core countries. Furthermore, the debt crisis put an end to the structural weakness of the dollar, removing the need to print more SDRs or invent an alternative form of liquidity.

The renewed liquidity, however, would have been compatible with a simple repegging of the currencies. To account for the move from fixed to floating, it is necessary to tap the domestic dimension. At the domestic level the financial cross-border externality—currency instability—was internalized. This internalization developed along two parallel tracks: key domestic players, notably treasuries, became dependent on access to international financial markets while devaluation became perceived as an intolerable source of inflation. I develop each point successively.

The Eurodollar market created sectors that were dependent on a stable access to international funding. Banks were the first to become dependent on the cheaper borrowing rates offered on the Eurodollar market. Yet, bankers were still a weak group politically and economically, hobbled by the regulatory shackles of the thirties. The turning point occurred in the aftermath of the oil shocks of the 1970s. The worldwide protracted economic crisis that ensued made governments dependent on the private bank's recycling of the petrodollars not just to pay for oil but also to keep afloat the welfare state in a period of declining tax revenues. This change turned indebted treasuries all around the world into powerful advocates of currency stability. But most importantly, the need to access private financial markets at low rates made treasuries ardent backers of financial deregulation. In all countries, legislatures deregulated the government bond market, liberalized branching and securities trading, privatized nationalized banks, and opened their financial markets to foreign competition, thereby consolidating the economic and political power of the largest banks.[65]

The use of devaluation even in moderation as a tool to enhance the welfare of the tradable sectors lost its appeal when it became clear, in response to the oil shocks, that it caused inflation. It caused inflation because most countries were dependent on oil and, as a result, saw the price of oil go up as the currency dropped, causing widespread inflation. Beyond oil dependence, competitive devaluation also caused inflation where the economy was highly dependent on price-inelastic imports or, past a threshold of trade interdependence, any type of import.[66] Inflation, when high and anticipated, triggered the indexation of prices and wages, eventually nixing the competitive effect of devaluation. Devaluation or undervaluation as measures to enhance competitiveness lost its usefulness in a world of capital mobility, triggering self-restraint in their use.

The 19th-century pro-gold coalition formed again, this time in support of inflation targeting, a task delegated to central banks made independent for the occasion. Exchange rate stability—also dubbed "dirty float" on account of the unusually-limited fluctuation between major currencies—merely followed from

[65] Verdier 2002: chap 8.
[66] Frieden 1994.

the setting of a domestic nominal anchor for price levels.

The supporters of a stable currency generally have regained some of their past importance, but they have not triumphed for all that. No democratic government that still has its own currency is willing to sacrifice internal stability to external stability. The first thing to go whenever there is a contradiction between the two levels is the valuation of the currency, promptly abandoned to market vagaries.[67]

The internalization of currency stability has not been sufficient, however, to overcome the latent problem between deficit and surplus countries. The United States turned into a deficit country, successively trying to get surplus countries such as Germany, Japan, and China to reflate their economies and/or let their currency float upward in order to alleviate the long-term imbalance. Only once, in the late 1980s, did surplus countries (Japan and Germany) agree to reflate under the threat of U.S. Congress protectionist action.[68] The utter failure of the policy—it fueled an asset bubble, the burst of which started the Japanese so-called "lost decade"—may have doomed it forever. As the purchase of silver in the 19th century, reflation today is a public good, which benefits all countries, but is better left to others.

The only case of informal transgovernmental agreement occurred in the field of banking regulation, where domestic financial instability forced the United States and Britain to increase capital adequacy requirements on their domestic banks first, and then negotiate an export of their domestic regulations to foreign countries, Japan especially, whose banks neither needed nor wanted such regulation, by linking the issue of capital adequacy with access to their financial markets.[69] In contrast, the failure of the two Anglo-Saxon countries to reach

[67] This assertion does not necessarily apply to the countries of the Latin American and South Asian periphery, which, on many occasions, sought to peg their currencies to the dollar against all odds, usually to end in failure.

[68] Webb 1991: 331.

[69] Kapstein 1989: 341; Oatley and Nabors 1998.

a common understanding on capital requirements for securities firms left the informal security regime, located within IOSCO, without a similar transgovernmental agreement.[70] Nevertheless, IOSCO members have negotiated hundreds of bilateral MOUs amongst themselves and one multilateral MOU on enforcement cooperation signed by 80 members.[71]

5.5 European monetary integration

The countries of the European Union have taken a different path than the countries that signed the Bretton Woods charter: in response to the end of fixed parities in 1971, they have established fixed parities among one another. This took the form of the so-called "currency snake" at first, then the European Monetary System and eventually, for a subset among them, the Eurozone. Why have the same countries that embraced informal governance with the dollar and the yen adopted formal governance with respect to one another's currency?

McNamara (1999) offered an ideational answer to European monetary integration, one that emphasizes the emergence of a neoliberal consensus among European political elites. Yet that same consensus led U.S. monetary policy in the opposite direction. I think rather that the explanation is specific to the forced pace of European integration. European leaders rammed the single market through European institutions for political reasons and limited concern for the uneven level of financial maturity reached by every member country, with the result that the trade incidence of exchange-rate adjustments under a system of floating acquired an acute relevance. Currency fluctuations were perceived to be a hindrance to trade flows.

[70] Singer 2007: 93.

[71] Raustiala 2002-2003: 31. Verdier 2009:144. See IOSCO List of Signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information available at http://www.iosco.org/library/index.cfm?section=mou_siglist (last visited October 18, 2011).

European were concerned with exchange rate instability for another reason: it interfered with the working of the Common Agricultural Policy. Shifts in exchange rates would force governments to temporarily impose tariffs on goods produced in the devaluing country and give export subsidies to those produced in the revaluing country. But, as Giavazzi and Giovannini (1990: 251) explained, once the temporary effects were spent, it was easier to remove the tariffs than the subsidies, causing the budget to swell and Europe to overproduce cereals.

The eventual move to the single currency had an even stronger political rationale. The Euro became a reality when Germany consented to abandon its beloved Deutsche mark as a quid pro quo for its neighbors' agreeing to a speedy reunification.[72] Matters of security are typically resolved by treaties, for the cross-border externality that is best captured by the notion of security dilemma rarely has a domestic extension or gets internalized in the absence of a formal commitment.

With the exception of European monetary integration, the history of the currency regime is well captured by the two-level externality approach. In what precedes, I showed that currency manipulation was a two-level externality, the domestic prong of which was felt strongly enough in periods of higher trade and investment interdependence to dispense with a formal treaty arrangement. I also showed that there was a direct connection between the globalization cycle and the ups and down in political power of the deflation coalition and the non-tradables. I also articulated the inverse relation between the latter groups' relative power and governmental preference for formalism. I now apply the same approach to the history of trade.

[72] Sandholtz 1993, Eilstrup-Sangiovanni and Verdier 2005.

6 Trade

Trade generates a two-level externality. A government's trade policy has a cross-border externality because it affects foreign exporters' right and ability to sell goods to the domestic consumers. Tariffs, quotas, preferences negatively affect foreign exporters' bottomline, whereas openness and the absorption of foreign goods have positive effects.

Trade policy also has a domestic externality, dividing domestic groups along the free trade-protection divide. Consumers and sectors that are dependent on foreign inputs are usually hurt by a protectionist policy whereas import-sensitive sectors and the factors of production that they employ are helped.

I draw in Figure 6 the negative externalities caused by a rise in protection in a two- country world. Country A's protectionists inflict a negative externality on country B's exporters and, at home, on domestic consumers and exporters. The two domestic effects are not identical—exporters are most often affected by foreign protectionists, not by domestic protectionists. They are also affected by domestic protectionists only when the country is small or protection extends to raw materials.

There are two ways that governments can hope to sustain a trade regime: if consumers organize to contain protectionists or if exporters do so. Although the two are usually collapsed together to account for resistance to protectionism, Figure 6 makes it clear that the logic behind their respective mobilization is different. Consumers are sensitive to the cost of living, raised by import taxes. Their large number means that they can only be mobilized through electoral politics, usually of a partisan nature. And when successfully mobilized, they are able to defeat protection and force free trade on protectionists without the need of an international agreement.

Exporters are in a very different situation from consumers: they are not so

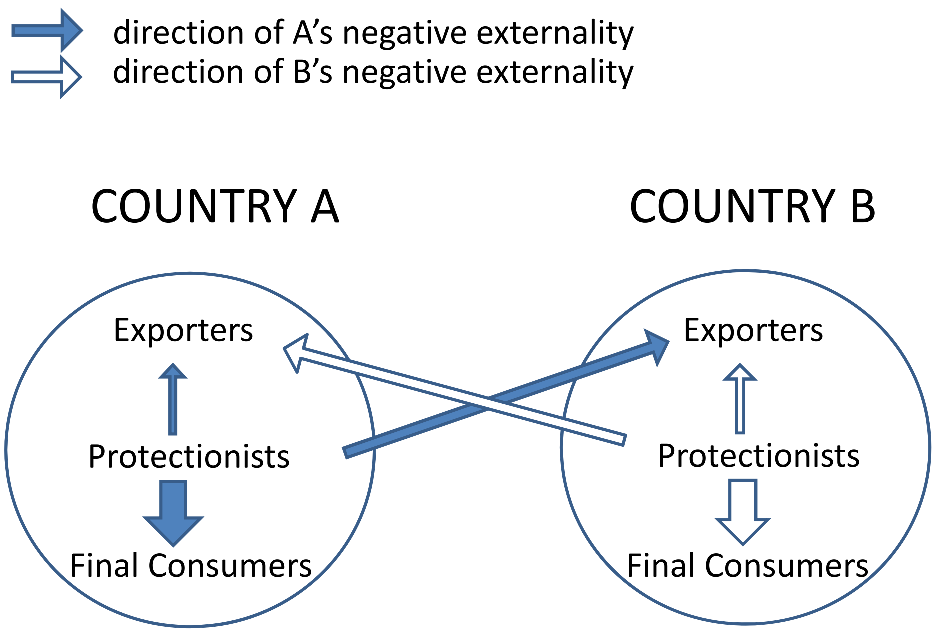


Figure 6: Negative Externalities Generated by Protectionist Policies

much the victims of the domestic externality, the way consumers are, but of the cross-border externality generated by foreign protectionism. Indeed, while consumers care about cost, exporters are mostly, though not exclusively, interested in accessing foreign markets. Although able to organize on their own and lobby their home government, they have no influence over the foreign governments whose markets they seek to access. Merely opposing protectionism at home is insufficient to deliver access to foreign markets. Also needed is the signing between governments of a reciprocal trade agreement listing the goods that are granted access and the conditions of their eventual revocation.[73] Given the mo-

[73]The rise of scale economies since mid-century, Yarbrough and Yarbrough (1982) further argued, required that access to foreign market be made secure and long-term through the signing of a multilateral instrument–the GATT.

tivational and tactical differences exhibited between a consumer and an exporter campaign against protection, it is unlikely that consumers and exporters would mobilize simultaneously to fight protectionism.

What might determine which type of campaign—consumer or exporter—to expect in what circumstances? The answer, as for currency matters, has something to do with the level of globalization (claim 1). I argue that consumer-based antiprotectionist campaigns are more common when trade and investment interdependence is high than when it is low, whereas exporter-based antiprotectionist campaigns are more likely when interdependence drops to low levels. The rationale for these claims goes like this: when interdependence is high, consumers potentially consume a significant share of imported goods, with the effect that further export opening brings significant benefits. When interdependence is low, however, little of what consumers consume is imported, reducing the benefit to be had from an eventual free trade campaign. Priorities are reverse on the side of the exporters. Exporters, who are always dependent on trade, suffer more from trade restrictions in a context of low interdependence than when interdependence is high.

I need to mention one caveat about the consumer-based antiprotectionist campaign: it needs a democratic setting, empowering the median voter. The exported-based antiprotectionist campaign, in contrast, is not regime-type dependent.

Trade and financial interdependence were high until 1914, declined between the wars, and rose again after 1945 (see Figures 4 and 5). Historically, consumer campaigns for free trade took place in the late-19th century until the interwar period, whereas exporter campaigns took place in the 1930s and afterward. New consumer campaigns are taking place today with respect to trade-related issues such as labor rights, the environment, and human rights. This periodization allows me to explain the timing of formalism in the trade regime: the regime was mostly informal (with significant exceptions caused by autocratic rule) until World War II and became formal then. Although, contra claim 1, it has remained formal with respect to trade issues in today's globalized economies, we still observe a rise in informal governance in trade-related issues.

6.1 Nineteenth-century trade

Support for free trade in the 19th century primarily came from consumers of imports. The foremost example was the British free trade movement, which, inspired by the new theories of Ricardo, pitted the textile industry against agriculture in the first half of the century and then labor and the export-oriented sectors of industry against the import-sensitive sectors of industry toward the end of the century. Each of these groups, at their respective time, were the largest electoral groups in a parliamentary regime that was progressively liberalizing the franchise, and their demands for free trade were successively articulated by the Liberals and the Labor party. The conservatives endorsed the demands of the protectionist agrarians at first and protectionist industrial sectors later on. The centrality of the tariff issue to electoral rivalry between the two sides of the Commons had legislators advocate the principle of "tariff autonomy," according to which tariff-making was a domestic issue that should not be delegated to executives, theirs and foreign ones, to lock in rates into international agreements for decades at a time. The tariff was primarily seen as a cost imposed on consumers, a tax issue, in which foreign interference was out of place.

Tariff autonomy may be considered as the underlying principle behind the 19th-century equivalent of an informal trade regime. By pursuing their enlightened interest, like-minded countries would unilaterally engage in free trade with each other. There was no transgovernmental network proper, but a flow of new ideas that spread across borders and helped coordinate national policies.[74]

The classic example of the reluctance to negotiate the tariff with trade partners was many-time British Premier Gladstone. Leader of the liberals, Gladstone used the free trade platform to appeal to the electorate. His party won all elections that happened to be fought on the trade issue—lots of them were—for almost a century (1848-1930). Gladstone and the liberals were ardent supporters of the tariff autonomy precept. Gladstone, however, made one exception in 1860 when he allowed Cobden to sign the famous Cobden-Chevalier treaty with France with the explicit purpose of defusing a risk of war between the two countries. Basically, it took a security emergency—a purely intergovernmental matter—and the linking of the tariff to it for Britain to make an exception to the principle of tariff autonomy. This was the only trade treaty that Britain negotiated throughout the century; all the other ones that London signed afterward were only mutual exchanges of MFN treatment.

Like Britain, the United States did but erratically engage in the signing of commercial treaties. The largest electoral group supporting free trade were the farmers. They were competitive enough to ignore foreign competition. They came in contact with tariffs as purchasers of farming equipment, fertilizers, paint, nails, and so forth. The tariff debate was articulated by the party system, with the Democrats advocating free trade, the Republicans, protection, while tariffs would move up or down according which side managed to control Congress and the Presidency. The "political football," as it was dubbed at the time, was not propitious to treaty making.[75] There were several attempts at depoliticizing the tariff. One proposal was to delegate its making to a nonpartisan tariff commission, while another was to sign reciprocal trade agreements with

[74] Kindleberger 1975.
[75] U.S. Tariff Commission 1919: 157, 224.

trading partners.[76] Advocated by moderate Republicans, both attempts were rejected by Democrats and stalwart Republicans, whose opposite preferences for respectively lowering and raising protection when political circumstances were favorable made them unwilling to freeze extant rates by writing them into treaties with foreign governments.[77]

Tariff autonomy as a regime-founding principle was not uncontested. The idea of a negotiated treaty system was also present. It is France that started the treaty system of the 19th century. Concerned that French industry had high production costs, Napoleon III sought to eliminate all duties on raw materials that were essential to industry—wool, coal, iron and steel. But rather than mobilize consumers, final and intermediate, he decided to bypass the French National Assembly's reluctance to do so and used his exceptional authority under a constitution that he had written for the occasion to sign trade treaties and lock in France into a ten-year commercial treaty with Britain. Although the overt goal of the treaty was not for French industry to get access to the British market—the only tariff concession that Chevalier extracted from Cobden was a lower duty on French wines—, the signing set off a chain reaction of treaties that France signed with other European governments and those governments in turn with one another, in which export promotion enjoyed pride of place.

We have here a classic example of an institutionally dominant incumbent tying his countrymen's hands and dictating the policy of successor governments (claim 4). More generally, the commercial treaty system arose at a very specific moment on the European continent, when all regimes East of France in the wake of the failed revolutions of 1848 were reverting to prior forms of absolutism. Generally favorable to the pro-free trade agrarian interests and less constrained than their predecessors by debilitated popular assemblies, they emulated the

[76] Becker 1982.

[77] The United States signed some treaties, mostly with Latin America; see Lake 1988.

French autocrat in joining the commercial treaty system.[78]

Both Britain and France extricated themselves from the treaty system as soon as they could, Britain in 1882, France in 1892. Although Napoleon did not expect the treaties to last more than ten years, circumstances and the fear of foreign retaliation extended their force by an extra twenty two years, a period during which the protectionist majority was unable to prevail.[79] While Britain reverted to a pure tariff autonomy stance, France tried to reconcile tariff autonomy with bargaining; the French Parliament adopted two tariffs, a maximum and minimum, the latter to be conceded to countries willing to reciprocate, yet with no guarantee that any duty would be kept unchanged.

Germany, in contrast, became the new anchor of a more modest treaty system known as the Caprivi treaty network. The Caprivi story is not dissimilar from the Napoleon III's story. Exercising the authority granted upon him by the Kaiser, Caprivi signed a round of treaties reducing, among others, the politically-sensitive wheat tariff. While Caprivi was brought down in 1894 by his fellow Junkers, his tariffs survived him by another eight years.[80]

In sum, the 19th-century trade regime was not a pure case of informal governance, but one that was tempered with spurts of negotiations of bilateral treaties. Tariff autonomy reflected domestic contestation (claim 3) while the treaty system was the doing of autocratic rule (claim 4).

6.2 Interwar trade

World trade in relation to output stagnated in the 1920s and collapsed in the 1930s.[81] With American farmers embracing price support and European labor embracing protection, the consumer approach to free trade fell apart, to be re-

[78] See Verdier 1998: 13.
[79] See Coutain 2009: 154-
[80] US Tariff Commission 1919: 481.
[81] Irwin 1995.

placed eventually by the exporter approach. Countries like the United States and the United Kingdom, which until then had followed the precept of tariff autonomy, retrenched to old and new trade treaty networks (British Commonwealth, U.S. treaties with Britain and Latin America) while Central Europe was linked to Germany through a web of barter agreements. The unilateral, *laisser-faire* approach to free trade was over.

This transformation happened in several ways. First, trade policy became intricately connected with monetary policy. The degree of protection afforded by a tariff agreed to after painstaking domestic bargaining could be undone at one fell swoop by a revaluation of the currency. Conversely, letting the currency float down had the same effect as raising domestic tariffs and lowering foreign tariffs. Slapping exchange control in order to stem capital outflows had the same effect as raising tariffs. In France, from the end of the war until the stabilization of 1926, tariffs were changed on a regular basis to take into account variations in the exchange.[82] In 1922, French tariffs were lowered to fight inflation. In 1930, American tariffs were raised to contain exchange dumping. Second, currency devaluation as a policy revealed the basic solidarity between all tradables, import-sensitive and export-oriented, because a devaluation had the twofold effect of promoting export and deterring imports.

In countries where tariff-making was still a legislative affair after the war, the crisis relocated the trade decisionmaking process to the executive branch.[83] Concomitant to the move toward executive authority was a promotion of corporatist intermediation. Producers were encouraged to organize and join trade associations, cartels, and price-fixing arrangements.

Free trade as *laisser faire* became obsolete. Exporters militated for the active intervention of government in favor of exports, either in the form of cur-

[82] Ogburn and Jaffé 1929: 546.
[83] For a comparative list of such reforms, see U.S. Tariff Commission 1934.

rency devaluation or bilateral trade agreements. Countries also created lending mechanisms similar to the U.S. Eximbank to provide loan guarantees to foreign importers.

The Great Depression discredited free trade and generated in its stead mass support for protection. Even in the United States, where protectionism took a hit after the Smoot-Hawley Republican fiasco, it was not easy for free traders to prevail. The Democrats no longer were the obvious champions of free trade, now that their agrarian base was asking for quotas and price supports while their labor base would equivocate for another decade. Reducing tariffs in Congress had become impractical.

As a result, Secretary of State Cordell Hull, an old-fashioned free trader, borrowed from the Republican toolkit the policy of signing reciprocal agreements with willing trade partners. Like the Republicans, who had used bilateral agreements to tie big exporters to the protectionist boat, Hull used them to smuggle trade promotion in an otherwise rather protectionist New Deal. With the 1934 RTAA, he obtained from Congress the authorization to modify some industrial tariffs—foodstuffs were off limits—in exchange for reciprocal concessions negotiated in treaties that bound the United States for periods of so many years, unless one signatory chose to invoke the escape clause that Congress mandated.

The State Department learned to promote exports without pitting export sectors against import-sensitive sectors and to target negotiations in such a way as to render ineffective the generalization of concessions through the MFN clause.[84] In the end, the tariff cuts were meagre. Although the ad valorem rate on dutiable imports into the United States declined from an average of around 50 percent in the 1930-34 period to about 37 percent in 1939, a seemingly impressive drop, the facts are that most of the reduction was attributable to

[84] Diebold 1941: 18.

the devaluation of the dollar[85] and the figure did not take into account the new quotas, which, by 1939, affected one-fourth of all dutiable imports.[86] However, with the advantage of hindsight, the RTAA was an important step on the way to the intergovernmental regime of the postwar era, because it is the statute under which the United States would successfully negotiate the first multilateral trade agreement, the GATT, in 1947 Geneva.

In sum, by 1939 trade had become an issue that could only be settled between governments. Both free traders and protectionists lost control over the tariff. Trade relations between countries had become PD games between unitary actors, yielding the suboptimal outcome absent intergovernmental cooperation.

6.3 The GATT

The trade controversy lost its domestic salience. From being an issue pitting protectionists against free traders, trade was recast as an international issue, pitting export-oriented expansion—Washington's policy preference—against domestic reflation—London's preference. At a time when trade had reached its lowest level in relation to world output, it was easy for every American voter to support export expansion abroad. Of course, it was equally easy for British of all political stripes to support full employment at home. All the more that, in 1946, when the protagonists gathered at Church House in London to draft the ITO charter, it was widely predicted that a serious American depression would develop within the coming year and that Washington would try to contain unemployment by pushing its products onto foreign markets at the risk of causing the latter to experience unemployment.[87] Trade heralded growth in the United

[85] Devaluation had two simultaneous effects: it increased effective protection by pricing out foreign goods, and decreased nominal protection by reducing the ratio of specific duties relative to price–which is what the percentages given in this paragraph measure. An ad valorem duty would not be so affected, but most U.S. duties were specific. See Mikesell 1952: 65.

[86] Whittlesey 1937: 65.

[87] Gardner 1969: 273.

States but presaged deflation in the United Kingdom.

As a result, the two delegations sparred on whether the charter should prioritize full employment, under what circumstances quotas could be reintroduced—payments difficulties only, as the American negotiators insisted, or unemployment as well, as their British counterparts so wished—and on what it would take for the British to give up imperial preferences.[88] Eventually, the two sides were too far apart, and the compromise arrived at by the delegations was not submitted to either the Congress or the British Parliament for ratification. Still, the GATT, which had been separately agreed in Geneva under the 1945 renewal of the authorization given to President Truman to reduce all tariffs by 50 percent, came into force.

Although less formal than the ITO would have been, had the latter been adopted, the GATT, a standing diplomatic conference with a small technical secretariat, firmly set the trade regime in the category of formal governance. Its transformation into the WTO in 1995 made it one of the most centralized multilateral regimes to have ever existed. The fact that the GATT/WTO presided over a long series of rounds that eventually dismantled practically all tariffs and made serious inroads in the removal of non-tariff barriers raises the obvious question of what happened to the protectionists. Has trade lost its domestic externality?

Protection obviously does have a negative externality on consumers of intermediate and final goods, but protection has been curbed if not completely eliminated in many sectors. What is surprising is not so much the absence of consumer mobilization as the absence of protectionist mobilization, which, had it happened, would have moderated the freeing of trade and, in turn, mobilized consumers the way things went in the 19th century (claim 1).[89] The protec-

[88] Gardner 1969: chap. 14.

[89] For instance, the reclaiming of the tariff by sdomestic groups from the intergovernmental process in late-19th century France was initiated by protectionist interests, in turn causing a

tionist dog failed to bark and its free-trade guardian failed to awaken for two reasons. First, protectionism, as a policy issue, fell under the cross-fire of the Cold War. The fact that in all OECD countries, free trade became a tool in the containment of the Soviet Union, a purely cross-border issue, made lobbying for protection difficult.[90]

Second, and more importantly, few import-sensitive sectors were hurt by trade liberalization. Those that were, agriculture at the outset, textiles in the 1950s, were taken off the GATT agenda and shielded with quotas when it became clear that liberalization would cause too much adjustment.[91] In addition, European countries created a welfare net, cushioning the adverse impact of trade openness on the work force.[92] Preventive measures were adopted to minimize adjustment costs in the first place. This was especially so with respect to industrial products, in which scale economies were sufficiently developed to allow for the substitution of intra-industry to inter-industry trade. I further develop this last point.

Intra- and inter-industry trade differ with respect to the adjustment costs they cause among factors of production. In the case of inter-industry trade, a country exports the goods that use intensively its abundant factors and imports the goods that use intensively its scarce factors. Trade develops along comparative advantages, redistributing income from scarce factors (and industries employing scarce factors) to abundant factors (and industries employing abundant factors), thereby hurting the scarce factors.[93] In the presence of scale economies, however, a country exports the products in which it has a first-mover advantage and imports those in which it does not.[94] That country loses

remobilization of free trade interests. See Coutain 2009.

[90] See Verdier 1994: 203-17.

[91] Aggarwal 1985.

[92] Bates, Brock, and Tiefenthaler 1991.

[93] Deardorff and Stern 1994.

[94] Krugman 1980.

products in some sectors, but at the same time gains other products in those same sectors, thereby maintaining a presence in all sectors—hence the notion of "intra-industry" trade. Because factor proportions are more homogeneous between products within a same sector than between products of different sectors, the shifts of factors of production induced by product-specialization tend to be factor neutral and thus with few adjustment costs, each factor of production moving from a "lost" product to a "captured" product within the boundaries of a given industry in equal proportion.[95]

Intra-industry specialization was not entirely left to market forces, but was managed by governments. GATT members engaged in intra-industry tariff cuts, limiting import concessions to those foreign industries that reciprocated with concessions on exports, so that the adjustment costs for any industry as a whole were low.[96] They used imperial preferences, import quotas, and VERs to maintain industrial diversity. And several among them, France and Japan notably, resorted to supply-side protection (planning, industrial policy), using subsidies and other product-specific instruments not covered by the GATT to secure a national presence in growth sectors.

The upshot of this carefully managed liberalization among GATT members was a significant rise in trade accompanied with little specialization, and thus few adjustment costs. Hufbauer and Chilas (1974) compared interwar with postwar sectoral trade specialization in eight countries and found no significant increase in specialization. Further studies recorded a rise in intra-industrial trade in most industrialized countries throughout the fifties and sixties (Grubel and Lloyd 1975).

The cold war emergency and the promotion of intra-industry trade went a

[95] Lundberg and Hanson 1986. Of course, there were also retooling costs, causing some protectionism: see Gilligan 1997.

[96] Hufbauer and Chilas (1974: 3-8) dubbed the GATT approach that of "balanced trade"; see also Lipson 1982: 449.

long way in containing protectionism. Still, this was not always sufficient. The rise of Japanese competition in the 1980s—Japan being at the time the OECD economy with the lowest level of intra-industry trade—caused severe frictions with other industrialized countries, the United States and Europe especially. This was the time when the governments of these countries violated the spirit of the GATT by forcing Japan to voluntarily restrain its exports, for fear that parochial legislatures violate the letter of the GATT. This is also when the United States unilaterally decided to enforce so-called "fair trade" with its infamous Section Super 301. Eventually, the regime bounced back from this difficult decade and augmented its past formalism with the creation of the WTO, extending the GATT secretariat and enhancing its dispute settlement mechanism. Although the WTO should be viewed as a triumph of formalism, it came loaded with options for informal governance, for instance by making the use of the escape clause provision of Article XIX more attractive.[97]

The advent of the WTO jars with the prediction that rising interdependence should make the trade regime less formal and along the lines of 19th-century tariff autonomy or the G-groups meetings on the currency. The causal arrow seems to have broken at the level of claim 2: even though trade generates a two-level externality today—many final consumers would be hurt by a protectionist backlash—this fifth-column is largely demobilized, leaving exporters and their government representatives the task of containing protectionism whenever protectionism raises its ugly head, as such was the case with the Bush steel tariffs, which were not repealed by U.S. steel consumers but by foreign steel exporters.[98]

Behind the demobilization of consumers is the success, so far, of foreign exporters in containing domestic protectionism through the formal mechanisms

[97] Pelc 2009: 359.
[98] See reference in the introductory paragraph.

set up by the trade regime, which, unlike Bretton Woods, has not broken down. Another reason is that the GATT works equally well with democratic and autocratic governments, whereas consumers' containment of protectionism only works in democracies, at a time when the trade volumes depend on the successful inclusion of China and other autocratic countries from Asia.[99]

Nevertheless, the trade issue today goes beyond the jurisdiction of the WTO and new consumer demands are appearing on the political scene, leading some observers to predict a softening of the trade regime.

6.4 The Softening of Trade

The success of the GATT at eliminating tariffs and import quotas and the strengthening of its dispute settlement system have led the member countries to extend the trade regime into so-called "trade-related" areas, such as intellectual property, foreign investments, and services. At the same time, trade liberalization has for several decades been touching on issues other than trade, such as environmental protection, labor standards, consumer and labor safety, and human rights. Along with the introduction of these new, popular issues into the trade debate, domestic hostility to corporate business and old-fashioned free traders has arisen, re-politicizing the trade issue. Concomitantly, some legal scholars have claimed to discern a softening of the trade regime.

A first, and probably least convincing, illustration of this new trend is the recent slide of the TRIPs Agreement from a hard and formal, pro-Western set of rules into a softer, pro-South "complex" of principles.[100] While this revisionism

[99] Still another reason for the persistence of the 1947 model into our globalized 21st century might be the Yarbrough's (1987) insistence on the need for secure market access in an era of large fixed costs. Still still-another reason may be consumers' collective action problems, felt even in a democratic context. Given that every consumer is also a producer, there are few classes of individuals today that have their trade preference as consumer aligned with their trade preference as producer, as such used to be the case with American farmers until the 1920s and European labor until the 1930s.

[100] Helfer 2004, Shaffer and Pollack 2010.

is driven by developing countries, their efforts are echoed by Western NGOs contesting the moral legitimacy of TRIPs.[101] The "revisionists" have moved negotiations over intellectual property to new and related regimes—biodiversity, public health, human rights, and plant genetic resources—where they have a greater control of the agenda and of the proceedings. Some of these related regimes are hard, while others are softer.[102] Such softening, however, seems temporary, for the result of deliberate forum shopping, a tactic geared to the modification of hard law and more likely to result in more hard law than in the dawn of a new informal regime.[103]

Of a different sort are the private governance agreements that have emerged in relation to the trade of certain products—diamonds, wood, clothing (Haufler 2001, Bernstein and Cashore 2004). Pressed by NGOs, multinational corporations in those sectors have agreed to voluntary codes of conduct or eco-labels and certification schemes. As claim 5 would suggest, governments are typically not involved or, if they are, in limited enough ways to stay out of reach of WTO scrutiny.

The private nature of these agreements makes them different from 19th-century style informal governance, in which politicians articulated the domestic debate. But the fact that in both cases domestic consumers are reacting to a domestic externality—higher cost of dutiable goods in the 19th century, political incorrectness of some corporate practices today—makes them analytically similar. What is unclear at this point, however, is the sustainability of these voluntary agreements in the absence of governmental endorsement, which, if it happened, would make them vulnerable to WTO hardened discipline.[104]

[101] Sell 2002.

[102] Helfer 2004, Shaffer and Pollack 2010: 774-.

[103] Nothwistanding Shaffer and Pollack (2010: 752, 769), the same caveat applies to two issues of contention between the United States and the European Union–genetically-modified organisms and audiovisual services.

[104] Sindico 2006.

7 Conclusion

The paper raised the question of the choice of the level of formalism by governments intending to reduce a cross-border externality. According to the literature, two distinctive paths are available: (1) a formal, top-down path, by which governments negotiate a treaty-based regime mandating the reduction of the externality and set up an appropriate enforcement mechanism; (2) an informal, emergent path, in which governments coordinate unilateral reductions of the externality or merely take notice of private agreements reached by private actors. Starting from the common idea that states reduce a cross-border externality by internalizing that externality, I proposed that governments prefer the formal path if the externality is purely of a cross-border type, and the informal path if the externality is two-level—it also has an internal dimension.

The main rationale of the argument is that informal governance, because it relies on stated intentions rather than legal commitments, can only be sustained if it is deeply anchored in the domestic fabric of each member government. It must have the active and support of a pro-regime coalition, which is strong enough to stand against the sectors of finance and industry that produce the externality. The stronger that domestic anchor is, the more cooperation can be achieved without a formal international agreement. Absent such a domestic anchor, however, governments' only hope is to cooperate by delineating a compromise, committing to it, and defining what constitutes a breach of obligation and corresponding sanctions—only a treaty offers the possibility of achieving such results.

An auxiliary rationale is that domestic politics, electoral or regulatory, has a dynamics of its own that brooks limited foreign interference. Having to manage the political balance between the perpetrators of the externality and their domestic victims, policymakers need enough margin of maneuver to try to please everyone. They are wary of tying their hands to actions pursued by other states. Since informal governance usually occurs in a context of globalization, policymakers also value availing themselves of policy flexibility to adjust to unexpected external blows dealt by the accrued economic dependence on the rest of the world. Although flexibility can also be had through formal devices such as limited contract duration, escape clause, and other safeguards, these come at an extra transaction cost.

The argument was further split into five more specific claims, which were applied to three periods of trade and currency regimes—before the Great Depression, during the interwar and its aftermath, and today. I systematically assess the match between each claim and each period.

Claim 1 linked the type of the externality to the level of globalization: purely cross-border if low, two-level if high. This claim was easily observed in both currency and trade areas, since the larger the percentage of the working population is dependent on trading with the rest of the world, the more, almost by definition, is it negatively affected by protectionism and currency instability.

Claim 2 linked the domestic alignment with the type of externality: consensual if purely cross-border, competitive. if two-level. This prediction was clearly observed only in four out of the six periods—the three periods of currency regimes and the intermediate period of trade. The prediction was not always observed in the first trade period, before the Great Depression, a period where the risk of protection did not systematically lead to a competitive. mobilization of free traders and protectionists. Such was the case in democratic regimes such as Britain, the United States, and France after 1892. It was not the case in autocratic regimes, such as France under the Second Empire, Germany and other autocratic regimes. The prediction is not observed in the current trade regime either, on account of the absence of mobilization of protectionists and free traders on a national scale. The Cold War and the promotion of intra-industry trade kept import-sensitive sectors demobilized.

Claim 3 linked the mode of governance to the domestic alignment, formal if consensual, informal if competitive. This link was observed in all three periods in both issue areas. Considering trade first, the issue was a partisan issue in early democracies, fostering tariff autonomy, whereas it was a consensual issue in autocracies, encouraging negotiations of bilateral reciprocity agreements. Starting between the wars and extending all the way to the present, various trade sectors converged around the need to promote exports while not hurting import-sensitive producers, which yielded formal bilateral and then multilateral agreements. The WTO ban, however, fostered domestic competition among OECD countries over politically correct forms of trade and instance of private governance.

Considering the currency, domestic alignments followed the market and political power of large commercial banks, high in periods of competition and deregulation, low in periods of regulation. The mode of international governance merely followed the oscillations in domestic regulatory regimes, informal under deregulation, formal under regulation.

Claim 4 provided a limited patch to claim 2, by conditioning claim 2 on the existence of democracy. It allowed me to make sense of the coexistence of bilateral reciprocity agreements with 19th-century tariff autonomy.

Claim 5 linked private governance to the multinational identity of the domestic perpetrators. It supplied a non-political outlet to the competitive. mobilization of perpetrators and victims, which came in handy to account for the emergence of private forms of governance in today's trade practices.

As for Lenin's chain of financial capitalism, the argument is as strong as its weakest link—claim 2. The two-level externality does not always politicize the debate between the perpetrators and the victims of the externality. It does not in the context of autocracy and in that of the WTO. Further research on issue areas other than trade and the currency is necessary to assess the extent of this exception and, perhaps, tease out the unexpected functional equivalence assumed by autocracy and the WTO in the context of the argument.

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