

Changing Global Financial Governance

International Financial Standards and Emerging Economies since the Global Financial Crisis



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Hyoung-kyu Chey



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About the New Thinking and the New G20 Project

The project aims to promote policy and institutional innovation in global economic governance in two key areas: governance of international monetary and financial relations and international collaboration in financial regulation. Sponsored by CIGI and the Institute for New Economic Thinking, the project taps new research and next-generation scholars in the emerging economies, linking them to established networks of researchers in the industrialized world. The objective over the longer run is to create a more permanent and self-sustaining research network that will provide a continuing stream of new ideas, sustain international collaboration and integrate researchers from the emerging economies into global policy discussions.

Miles Kahler and Barry Eichengreen (principals in the original project) recruited C. Randall Henning (new principal, American University) and Andrew Walter (University of Melbourne) to lead two research teams devoted to macroeconomic and financial cooperation and to international financial regulation. Gathering authors from eight countries, the project consists of 11 CIGI papers that add to existing knowledge and offer original recommendations for international policy cooperation and institutional innovation. CIGI will also publish the final papers as an edited volume that addresses the global agenda in these issue-areas.

About the Author



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Acronyms

BCBS	Basel Committee on Banking Supervision
CCP	central counterparties
CPMI	Committee on Payments and Market Infrastructures
FSB	Financial Stability Board
FSF	Financial Stability Forum
G7	Group of Seven
G20	Group of Twenty
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
OTC	over-the-counter
RCAP	Regulatory Consistency Assessment Programme
SIFI	systemically important financial institutions
SSB	standard-setting bodies
TR	trade repositories

Executive Summary

One of the most remarkable changes in global financial governance since the 2008-2009 crisis has been the primary forums that establish international standards extending their memberships to include emerging economies. There are two disparate perspectives in the literature on the impact of this change on international financial regulation: the weakening cooperation view, which sees an attenuation of international cooperation due to this change, and the enduring status quo view, which sees the domination of global financial governance by advanced economies persisting even despite it. This paper presents an alternative — more positive — perspective. It argues that extending membership to include emerging economies has, to some extent, actually strengthened their role in the rule-making process related to international standards, by allowing them to participate in that process from the very beginning. Their role, however, has been constrained due to their shortages of regulatory expertise, and has focused mainly on the defensive dimension of mitigating the negative effects of international standards on emerging economies. In addition, their lack of available resources significantly limits their ability to actually incorporate their preferences into international standards. The research presented in this paper also argues that the expanded membership has had positive impacts on emerging economies'

compliance with international standards, by increasing their exposure to external compliance pressures and also by heightening compatibility between their own regulatory preferences and the international standards. These findings suggest that a further strengthening of emerging economies' inclusion in the rule making related to international financial standards is likely to enhance rather than hinder international cooperation in this area.

Introduction

The formal participation of major emerging economies in the rule-making process related to international financial standards is one of the most significant changes in global financial governance since the 2008-2009 crisis. Until the crisis, the key standard-setting bodies (SSBs) were dominated by a handful of advanced economies. The membership of the Basel Committee on Banking Supervision (BCBS), the rule setter for international standards in the field of banking regulation, had consisted of the Group of Ten countries. The Committee on Payments and Market Infrastructures (CPMI),¹ which is in charge of international standards in payment, clearing and settlement, had restricted its membership to the Group of Seven (G7) countries, plus Belgium, the Netherlands, Singapore, Hong Kong, Sweden and Switzerland. The Financial Stability Forum (FSF), a coordinator of national financial authorities and SSBs, had also included the G7, plus Australia, Hong Kong, the Netherlands, Singapore and Switzerland. The International Organization of Securities Commissions (IOSCO), the standard setter for securities regulation, did have a broad country membership, but its Technical Committee, from which its core regulatory initiatives had stemmed, had members from the G7 countries only, plus Australia, Hong Kong, Mexico, the Netherlands, Spain and Switzerland (Helleiner and Pagliari 2010, 3-4). Although the Group of Twenty (G20), whose membership included the major emerging economies of Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea (henceforth Korea) and Turkey, was inaugurated in 1999, prior to the crisis it held only finance ministers and central bank governors' meetings, and global economic governance was led mainly by the G7. There had, consequently, been a clear distinction between "rule makers" and "rule takers," the former group comprising only a limited number of advanced economies and with emerging economies belonging to the latter.

The global financial crisis has transformed the structure of global financial governance, however. It was the first truly *global* financial crisis of the postwar era, and given the considerable increase in the role of emerging economies in the world economy, their cooperation became essential for the effective

¹ The Committee on Payment and Settlement Systems was renamed as the CPMI in September 2014.

management of the crisis.² The leaders forum of the G20 was created in November 2008, as the premier forum for global economic governance. The memberships of the key SSBs have also been widened to include major emerging economies. The Financial Stability Board (FSB), which was established as the successor to the FSF in 2009, and the BCBS have extended their memberships to incorporate all G20 members. The CPMI has opened its membership to Brazil, China, India, Korea, Mexico, Russia, Saudi Arabia and South Africa. In addition, Brazil, China and India have joined the IOSCO's Technical Committee (Helleiner 2014, 138). The G20 has led initiatives for the reform of international financial regulation to prevent future crises, outlining a road map for this reform and assigning to the FSB and other SSBs the responsibilities for producing new international financial standards. As a result, major emerging economies have finally joined the "club organizations" that formulate international financial standards.

This remarkable change in global financial governance raises the following important questions: Do emerging economies *actually* play significant roles as rule makers? Does their participation in the process of establishing international standards affect their compliance with those standards? And does the inclusion of emerging economies in the rule-making process ultimately deepen or weaken international cooperation in this area? This paper attempts to address these issues.

There are two different major perspectives in the literature on this subject. One is the weakening cooperation view,³ which presents a largely negative perspective of the impact the increased representation of emerging economies in international standards setting has on international cooperation. This view holds that the inclusion of emerging economies in the rule-making process makes it harder to reach international agreements, stressing that they have regulatory preferences distinct from those of advanced economies. The other perspective is the enduring status quo view,⁴ which argues that little has changed despite the crisis. There are, in fact, discrepancies among those sharing this latter perspective, in terms of their normative judgments of the desirability of this outcome. They nonetheless share the assessment that global financial (or economic) governance is still led primarily by advanced economies, in particular the United States, due largely to its persistent dominance and leadership.

These two perspectives both have notable limitations, however. The weakening cooperation view appears to presuppose the ability of emerging economies to formulate their original regulatory frameworks, as well as to actually incorporate their preferences into the international standards. But these two

issues should be subjects of empirical research rather than assumption. The enduring status quo view, meanwhile, rarely provides systematic direct analysis of emerging economies themselves, instead placing its analytical focus mainly on the leading powers, in particular the United States. As a result, the role of emerging economies in post-crisis global financial governance tends to be either indirectly or implicitly examined, rather than analyzed directly and explicitly. In addition, neither of the two perspectives offers much systematic research on the impacts of emerging economies' new SSB memberships on their compliance with international standards — they mainly examine only the rule-making processes. Most studies also tend to address the consequences of the extension of SSB membership to include emerging economies as part of their broader analysis of the overall nature of post-crisis global financial or economic governance, rather than undertaking more devoted and systematic research on the subject.

This paper provides an alternative — and more positive — view of the increased representation of emerging economies in global financial governance related to international financial regulation, by offering a direct and systematic analysis of its effects on the role of emerging economies in the international standard-setting process and on their compliance with these standards. Concerning the role of emerging economies as rule makers, the paper argues that, compared with the pre-crisis period (when emerging economies were not allowed to participate in the process), the extension of SSB membership to emerging economies does strengthen their influence in the formation of international standards to some extent, by allowing them to be involved in the design of standards from the very beginning. It also holds, however, that their lack of regulatory expertise — which is a structural factor stemming from the lower levels of development of their financial markets — is likely to reduce their abilities to devise their own original regulatory frameworks, thereby limiting their role in the rule-making process to primarily the defensive dimension of attenuating the negative impacts of international standards on their own economies. In addition, emerging economies' capacity to actually incorporate their regulatory preferences into international standards is significantly constrained, as they have few resources to use for achieving this end. This paper argues that emerging economies are now meaningful, but still constrained, rule makers.

Emerging economies' new SSB memberships are likely to have positive effects on their compliance with international standards through two distinct mechanisms. On the one hand, emerging economies' exposure to external compliance pressures, from both peer groups and the markets, is likely to increase, owing to the monitoring by SSBs of their members' implementation of and compliance with international standards. On the other hand, the compatibility between emerging economies' regulatory preferences and international standards can be enhanced in cases where emerging economies have actually incorporated their preferences in the formation of standards, although as mentioned above, their ability to do so is still limited. These

2 The share in world GDP of non-G7 members of the G20 rose from 13.8 percent in 1992 to 21.6 percent in 2007.

3 See, for example, Helleiner and Pagliari (2011), Helleiner (2012), Singer (2010) and Wade (2011).

4 See, for example, Drezner (2014) and Helleiner (2014).

arguments suggest that the increasing participation of emerging economies in global financial governance is likely to strengthen, not hinder, international cooperation on financial regulation.

The remainder of this paper is organized as follows. The next section reviews the literature on the consequences of emerging economies' inclusion in the rule-making process related to standards for international financial regulation. The following section articulates the main arguments of this paper, and the section after that introduces the major international financial standards established since the recent crisis. The subsequent two sections provide empirical analyses, focusing first on the role of emerging economies as rule makers for international financial standards and then on their compliance with these standards. The final section summarizes the major findings of this research and discusses their implications for global financial governance.

The Literature

There are two disparate perspectives on the impact of extending membership in the SSBs on international financial regulation to include emerging economies: the weakening cooperation view and the enduring status quo view.

The weakening cooperation view tends to be presented mainly by early studies of global financial governance since the crisis, including Helleiner and Pagliari (2011), Helleiner (2012), Singer (2010) and Wade (2011). This perspective holds that the participation of emerging economies in the SSBs — together with other factors such as the decline of US leadership, the politicization of financial regulation and the erosion of Anglo-American regulatory prestige — attenuates international cooperation on financial regulation. According to this view, emerging economies have regulatory preferences distinct from those of advanced economies, and their inclusion in the process of establishing international standards is thus likely to make reaching international agreement more difficult. Even when agreement is reached, it is likely to be on general principles that allow substantial national policy discretion, rather than on prescriptions of detailed rules (Helleiner 2011, 2012). Moreover, there are still no international bodies that can effectively enforce compliance with international standards; the international standards, in other words, remain “soft law,” and, as a result, some countries may not implement them in full or in earnest (Helleiner 2011; 2012; 2013; Helleiner and Pagliari 2011). Consequently, the inclusion of emerging economies in the SSBs in the post-crisis era is likely to weaken international cooperation on financial regulation.

In contrast, more recent studies such as Drezner (2014) and Helleiner (2014) present the enduring status quo view, with regard to the nature of post-crisis global financial governance in general, as well as to the role of emerging economies in it, although there are noteworthy variations in their normative

assessments of this outcome.⁵ According to this perspective, although there has been meaningful progress, such as the strengthening of international financial standards in coping with the recent crisis, the crisis has not generated dramatic changes in the nature of global financial (and also, more broadly, economic) governance. The global economic and financial system still remains fundamentally open and market friendly. The persistence of the status quo is attributed largely to the minimal change in the global distribution of power, and to the enduring leadership and dominance of the United States. The post-crisis international financial reforms, including the establishment of new standards, have still been led by the great powers, in particular the United States, with the reforms having been shaped heavily by US priorities. The challenges to American leadership have turned out to be less significant than anticipated. Emerging economies, including China, have played low-key roles in international financial regulatory reform, remaining cooperative with the Western powers in maintaining the open world economy. Nothing much has changed despite the mega shock of the crisis (Helleiner 2014).

These two perspectives have some notable limitations, however. The weakening cooperation view presumes that emerging economies have the capacities to formulate their own original financial regulatory frameworks. Moreover, it also presupposes that they have the ability to effectively reflect their own preferences in the formation of international financial standards. These assumptions are questionable, however, and need empirical verification. The enduring status quo view does not directly address the role of emerging economies in post-crisis global financial governance. Instead, it places its analytic focus mainly on the roles of the leading powers, which are the primary actors in global financial governance. As a result, systematic research on emerging economies is largely missing, and when it does occur, is often implicit rather than explicit.

In addition, both of these perspectives lack common sophisticated analyses of the impacts of opening club membership to emerging economies on their compliance with international standards. Instead, they discuss mainly their roles in the rule-making process. Some studies do examine the aspect of compliance;⁶ however, their analyses tend to centre on general compliance problems at the international institutional level, such as the soft law status of international financial standards mentioned earlier, rather than exploring the specific relationship between emerging economies' SSB membership and their compliance with international standards. Most studies also tend to examine the consequences of the extended SSB memberships as part of their broader analyses of the overall effectiveness or nature of global financial/economic governance

5 For instance, Helleiner (2014) appears to present a more disappointed judgment on the status quo bias of the post-crisis outcomes, while Drezner (2014) expresses a much more positive view, applauding that “the system worked.”

6 See, for example, Helleiner (2013; 2014).

since the crisis, rather than dealing with that subject as their core research agenda.

This paper attempts to supplement these significant shortcomings in the literature. First, it directly addresses the impacts of emerging economies' participation in the process of international financial standards rule setting on international regulatory cooperation, by placing the analytic focus more closely on the emerging economies themselves. It also provides an in-depth analysis of emerging economies' influence in the formation of international financial standards. Further, the research offers a systematic analysis of the relationship between emerging economies' SSB memberships and their compliance with international standards.

The Argument

This section articulates the main arguments of this paper, based on a *ceteris paribus* assumption. The inclusion of emerging economies in the primary SSBs is considered likely to strengthen their ability to influence the formation of international financial standards to some extent. Owing to their lack of regulatory expertise, however, emerging economies' role as rule makers is likely to be primarily limited to a defensive position, that is, to mitigating the adverse effects of international standards on their own economies. In addition, emerging economies' ability to actually incorporate their preferences into international standards is likely to be significantly constrained due to their weak financial power. Meanwhile, extending SSB membership to emerging economies is likely to enhance their compliance with international standards through two discrete channels: by increasing their exposure to external compliance pressures, due to the SSBs monitoring their members' implementation of and compliance with international standards; and, in areas where their preferences have been actually incorporated into the design of international standards, by strengthening the compatibilities between emerging economies' own regulatory preferences and the standards.

Rule Making

Emerging economies joining the chief clubs for setting international financial standards is certainly a remarkable change in global financial governance, in that they have finally been given an *opportunity* to play meaningful roles in the establishment of international standards, as formal rule makers. Yet how much they can *actually* utilize this opportunity is another matter altogether. Compared with the pre-crisis period, when emerging economies were mere rule takers, their SSB memberships in the post-crisis era are likely to enhance their ability to influence the construction of international standards to some extent. Their ability to do so, however, is likely to still be constrained, due to their weaknesses in both regulatory expertise and financial power.

First, emerging economies tend to fall short of having the regulatory expertise necessary to design *international* financial regulatory frameworks applicable to a large number of countries. One's knowledge of certain issues is affected by one's familiarity with them, which is also influenced by the magnitude of one's stake in them. In this regard, in relation to financial regulation, and especially in dealing with sophisticated issues such as prudential regulation, emerging economies are at a disadvantage vis-à-vis advanced economies due to the lower levels of development in their financial markets.⁷ Financial innovations tend to be driven largely by the financial markets in advanced economies, and many of the regulatory issues do not exist in emerging economies. It is thus difficult for emerging economy regulators to become familiar with regulatory issues in advanced economies, and their stakes in regulating those issues also tend not to be high, at least in the short term. Moreover, as the international financial standards aim to address the risks threatening global financial stability, risks in the major financial markets tend to attract more attention.

Given all of these factors, emerging economy regulators tend to fall short of the state-of-the-art regulatory expertise required for the formation of international financial regulations. Importantly, emerging economies' shortage of regulatory expertise is a *structural* problem that is difficult for them to overcome, insofar as the development of their financial markets lags behind that of advanced economies. It is therefore hard to expect emerging economies to play proactive roles in the establishment of international financial standards, by, for example, setting agendas and proposing original overall regulatory frameworks.

This being said, the capability of emerging economies to avoid various adverse effects of international financial standards is likely to be strengthened due to their formal participation in the process. Although emerging economies do not have regulatory expertise strong enough to propose original overall regulatory frameworks, they have the ability to assess the potential impacts of the regulatory proposals initiated by advanced economies. They can, therefore, demand — during the process of designing international standards — the adjustment or revision of particular provisions expected to have substantial negative impacts on them.

Such opportunities were not available to emerging economies during the pre-crisis era, when they were mere rule takers. Although consultation processes inviting comments on proposals for new international standards did exist at that time, the period allowed for review tended to be short (usually only three to four months). Moreover, SSBs had no obligations to respond to external comments. These factors discouraged emerging economies from actively participating in the

⁷ In the 2012 financial development index of the World Economic Forum (2012), the average score of the existing advanced economy FSB (FSF) members was 4.79 (in a range from 1 to 7), while that of the new FSB emerging economy members reached only 3.47.

consultation processes. Indeed, in all commentary on the BCBS consultative papers on Basel II in the early 2000s, emerging economies accounted for less than 20 percent (Walter 2014, 19).⁸ The extension of SSB memberships to emerging economies is surely a meaningful change in global financial governance, as it allows them to participate formally in the rule-making process from the very beginning, thereby providing them opportunities to at least defend their interests.

Nonetheless, the significance of this change in post-crisis global financial governance should *not* be exaggerated. Emerging economies' capacity to actually reflect their preferences in international financial standards still remains severely constrained. In explaining a country's influence in establishing international financial standards, the literature generally stresses financial market power as a primary factor.⁹ A country's financial market power is its structural power in the global economy, stemming from the importance of its financial markets and institutions. A country with financial market power is able to control foreign access to its important financial markets. It is thus able to pose threats of market closure to financial institutions from non-cooperative foreign countries and thereby bend the international negotiations on international financial standards in its favour (Drezner 2007; Kapstein 1992; Oatley and Nabors 1998).

It is generally regarded that only two economies hold such great financial market power: the United States and the European Union (or, according to some, the United States and the United Kingdom) (Drezner 2007). Indeed, the establishment of Basel I, for instance, which was the beginning of the international harmonization of financial regulation, has been frequently attributed to the financial market power of the United States and the United Kingdom.¹⁰ In contrast, no emerging economies hold such financial market power, meaning that their influence in negotiations over international financial standards is weak. The size of all emerging economies' capital markets combined is still smaller than either the United States or the euro-zone capital markets (Drezner 2014, 118).

Even countries without strong financial market power have of course sometimes successfully reflected their preferences in international standards. One good example is Japan in the formation of Basel I in the late 1980s, a story that has long been neglected in the literature, despite the considerable research devoted to the analysis of the creation of Basel I. In

contrast to the conventional view that Japan was the major victim of Basel I, a recent study by Chey (2014, 23–40) reveals that the Japanese regulators were able to obtain considerable concessions from their US and UK counterparts in designing Basel I in such a way as to significantly reduce Japanese banks' costs of compliance with it.¹¹ The Japanese regulators were able to do this because Japanese banks were strong competitors to US and UK banks in the international financial markets at that time.¹² Without the participation of Japan in Basel I, Japanese banks could have enjoyed competitive advantages vis-à-vis US and UK banks due to the less stringent Japanese domestic regulations. US and UK banks, therefore, put great pressure on their regulators to include Japan in Basel I, which strengthened Japanese leverage in the international negotiations.¹³ In contrast, however, emerging economy banks today pose little competitive threat to advanced economy banks, reducing their regulators' leverage in the negotiations on international standards setting.¹⁴

Also, although some emerging economies — such as China — have become large holders of advanced economy liabilities, it is not clear whether and how that might boost their international powers. The urgent need for financial support from emerging economies has subsided. Meanwhile, the credibility of blackmail by threatening to sell off their foreign assets is doubtful, as that would significantly hurt their own interests. For example, any dumping by China of its US dollar holdings would substantially reduce the value of its remaining dollar holdings, while also significantly weakening its export competitiveness through the resulting abrupt dollar depreciation (Chey 2012, 62).

Emerging economies appear to fall short of having the necessary financial power to enhance their influence in the process of international financial rule making. As a result, even if emerging economies demand adjustment or revision of regulatory provisions initiated by advanced economies, the acceptance of such demands is ultimately likely to be determined by advanced economies' own willingness to go along. Advanced economies are most likely to accept emerging economies' demands when doing so does not have high costs for them.

8 Emerging economy official commentary on BCBS consultative papers has in fact also not increased in the post-crisis era (Walter 2014). As Walter (2014, 16) notes, however, this may be due to the norm that BCBS members should express their views within the BCBS process rather than through public commentary.

9 See, for example, Drezner (2007), Kapstein (1992; 1994), Oatley and Nabors (1998) and Singer (2007).

10 See, for example, Kapstein (1992; 1994), Oatley and Nabors (1998) and Singer (2007).

11 The bursting of the bubble in the Japanese economy in the early 1990s substantially increased Japanese banks' costs of complying with Basel I. However, neither Japanese regulators nor banks had expected this in the 1980s when they were negotiating on Basel I, and both groups were satisfied with its provisions when it was created in 1988 (Chey 2014, 23–40).

12 For example, the volume of international lending by Japanese banks exceeded that of US banks in 1985 (Singer 2004, 554).

13 Japanese regulators also strategically reduced their domestic “win-set” by revising their domestic banking regulations in 1986 (Chey 2014, 34–37).

14 For instance, according to Bank for International Settlements data, the international asset volumes of US and UK banks amounted to almost US\$4 trillion each in the second quarter of 2014, while the corresponding figure for the reporting emerging economy with the largest volume of international assets (Brazil) marked only US\$328 billion. (Chinese banks did not report their asset sizes.)

Compliance

The new SSB memberships of emerging economies may strengthen their incentives to comply with international standards through two distinct mechanisms. First, where SSBs conduct strong monitoring on their members' implementation of and compliance with international standards, their members — both emerging and advanced economies — are more exposed to external compliance pressures. Second, where emerging economies have succeeded in having their preferences incorporated in the establishment of international financial standards, the compatibility between their regulatory preferences and the standards increases, accordingly strengthening their incentive to comply.

As the weakening cooperation view notes, the SSBs themselves still do not have power to enforce compliance with international standards. If they strongly monitor their members' implementation of, and compliance with, standards, however, this is likely to strengthen members' incentives to comply by increasing the external pressures on them to do so — more precisely speaking, the external compliance pressures on them that they themselves perceive.¹⁵

The external compliance pressures that SSB member countries perceive themselves as facing can take various forms. One is the risk of market closures in foreign countries to financial institutions not in compliance with international standards (Kapstein 1994; Simmons 2001). Market compliance pressures can also emerge where market participants use international standards as reference points for evaluating financial institutions' competitiveness and soundness, and penalize those not meeting them (ibid.). And, in fact, even during the pre-crisis period, when emerging economies were not SSB members, most of them did “voluntarily” adopt and comply, at least on the surface, with international standards set exclusively by advanced economies, and they did so due mainly to these two kinds of external compliance pressures (Chey 2014). Yet, emerging economies formally joining the key SSBs may still amplify these external compliance pressures, given the increased SSB monitoring of their compliance with standards. In addition, the new emerging economy SSB members may feel peer group pressures within the SSBs, a novel form of external compliance pressures on them arising from their new SSB memberships. The new SSB emerging economy members may wish to be recognized as “responsible” members, which will likely reinforce the peer group compliance pressures that they perceive.

15 In this context, the empirical research of this study on emerging economy compliance with international standards does not directly analyze whether external compliance pressures actually took place or not, as it deals mainly with emerging economies' perceptions of them. In fact, Chey's (2007; 2014) research on Basel I compliance demonstrates that, although there was little actual market compliance pressure for compliance with Basel I, a majority of regulators (mis)perceived that non-compliance with Basel I would be penalized by market participants.

As recent research on compliance with international financial standards has shown, the effectiveness of such external compliance pressures may be limited.¹⁶ Indeed, lax implementations of, and resulting “cosmetic compliance” with, international financial standards have been frequent in a number of countries formally complying, even including SSB members, suggesting external compliance pressures may not always be effective in ensuring compliance (Chey 2006; 2014; Walter 2008). Compliance with international standards tends to be determined ultimately by national regulatory authorities' willingness and ability to comply (ibid.).

Notably, the extension of SSB memberships to include emerging economies is also likely to reduce the cosmetic compliance problem, at least to some extent, by amplifying their voluntary willingness to comply. Where the compatibility between national regulatory preferences and international standards is higher, the national regulatory authorities tend to be more willing to comply, with the reverse being true where it is lower (Chey 2014). As discussed above, extending SSB memberships to emerging economies is likely to increase the likelihood that their preferences can be reflected in international financial standards, although not always ensuring it. Where their preferences are actually incorporated into international financial standards, emerging economies' willingness to comply is likely to strengthen.¹⁷

The following three sections provide empirical evidence supporting the arguments made in this section, by addressing the role of emerging economies in the formation of the new international financial standards established since the recent crisis, and examining their compliance with them.

International Financial Regulatory Reform

In the wake of the global financial crisis, the G20 undertook a reform of global financial regulation, which has led to the

16 See, for example, Chey (2006; 2007; 2014) and Walter (2008). The effectiveness of threats of market closure is likely to decline substantially for countries whose financial institutions have limited overseas business. In addition, it is in practice often not easy to evaluate whether a country violates international standards, due partly to ambiguities in their provisions. Market pressures for international standards compliance are also in practice unlikely to emerge easily, given market actors' reluctance to use international standards set by regulators as desirable reference points. A different kind of market compliance pressures may emerge as a result of domestic compliance enforcement by the national regulatory authorities, as regulatory penalization of financial institutions has a negative effect on them while also signalling that they have serious problems. This type of market compliance pressure is, however, a reflection of domestic compliance enforcement by national regulators (Chey 2006; 2007; 2014).

17 In addition, the extended SSB membership may have positive effects on emerging economy regulatory authorities' abilities to comply, since they can use their SSB membership as a means of forcing domestic financial institution compliance with international standards.

establishment of a new set of international financial standards. Prior to the crisis, standards focused mostly on microprudential regulation, with strengthening the soundness of individual financial institutions the main goal. The new international standards have improved microprudential regulation. Basel III, for instance, which has replaced Basel II as the international standards for bank regulation, includes a set of new microprudential elements — among them the reinforcement of capital quality, the introduction of a “leverage ratio” regulation, and the adoption of a framework for regulating liquidity based on “liquidity coverage ratio” and “net stable funding ratio” regulations.

Yet, one of the most remarkable aspects of the new international standards is their adoption of macroprudential regulation. Macroprudential regulation aims to tackle systemic risks, with a focus specifically on their time dimension, which reflects pro-cyclicality, and on their cross-sectional dimension, which reflects the distribution of risk in the financial system at a given point in time (International Monetary Fund [IMF] 2011a: 8–9).¹⁸ For instance, Basel III has adopted a “capital conservation buffer” and a “counter-cyclical capital buffer,” as tools to address pro-cyclicality. It has also employed capital surcharges on “systemically important financial institutions” (SIFIs) — “global systemically important banks” and “domestically systemically important banks” — as a means of coping with the cross-sectional dimension of systemic risk.

The new international standards have, in addition, extended the regulatory perimeter to areas that had been only weakly or rarely regulated prior to the crisis and, as a result, had aggravated systemic risk propagation during it. One example is the regulation of over-the-counter (OTC) derivatives markets, which requires the trading of all standardized contracts on exchanges or electronic trading platforms where appropriate, the clearance of all standardized contracts through central counterparties (CCPs), the reporting of contracts to trade repositories (TRs) and higher capital requirements and minimum margining requirements for non-centrally cleared contracts. The monitoring and regulation of the shadow banking system — generally defined as “credit intermediation involving entities and activities (fully or partially) outside the regular banking system” (FSB 2013) — has also been enhanced. Moreover, in order to reform compensation practices in the financial industry in a way that supports financial stability, principles for sound compensation practices and standards for their implementation have been created to ensure the alignment of compensation with prudent risk-taking, particularly at SIFIs. Key attributes of effective regimes for financial institution resolution have also been introduced to facilitate the resolution of insolvent financial institutions without causing severe systemic disruption.

18 For the intellectual history of macroprudential regulation, and its emergence since the recent crisis as the predominant regulatory concept, see Baker (2013) and Clement (2010).

Meaningful but Restricted Rule Makers

How influential have emerging economies been as rule makers in the establishment of the new international financial standards? They have played some meaningful roles, in particular, in preventing adverse effects of the standards on themselves. Yet their influence as rule makers has still been constrained due to their shortages of regulatory expertise and the power to achieve their preferences.

The formation of the overall framework of new international financial standards has been led mainly by advanced economies, just as it was prior to the crisis.¹⁹ The major confrontations in the course of designing standards have, in fact, been mainly among advanced economies, rather than between them and emerging economies.²⁰ For instance, during the creation of the Basel III capital framework, the United States, the United Kingdom, Switzerland, the Netherlands and Sweden preferred stricter regulations, while Germany, France and Japan were in favour of more lenient ones (Drezner 2014, 95; Helleiner 2014, 104). In part, this conflict reflected distinctive features of advanced economies’ own financial systems. Non-financial firms’ reliance on bank credit, for example, was greater in France and Germany than in the United States or the United Kingdom, meaning that the new capital framework would have wider impacts on the former group (Helleiner 2014, 104). Conversely, with regard to the IOSCO’s new regulatory standards for hedge funds, Germany and France favoured tighter regulation, but the United States and the United Kingdom, which together accounted for about 85 percent of all hedge fund assets under management, opposed it (*ibid.*, 108–9).

Meanwhile, rather than presenting their own original frameworks, emerging economy members of SSBs have merely supported the proposals initiated by advanced economies that are most acceptable to them.²¹ Emerging economies have, in general, preferred strong international standards, as their financial sectors have been relatively sound.²² And indeed, the new emerging economy members of the BCBS have tended to favour stricter bank capital regulation (Drezner 2014, 95; Helleiner 2014, 104). It is true that many of the new international standards have been weakened relative to the initial plans. Many major components of Basel III, for example — including the level of minimum capital requirements, the leverage ratio, the minimum liquidity ratios and the capital surcharge for SIFIs — were substantially watered down from their original plans

19 Author interview with an emerging economy regulator, August 25, 2014. The names, positions and affiliations of all interviewees are undisclosed at their request.

20 Author interview with an emerging economy regulator, August 25, 2014.

21 Author interview with an emerging economy regulator, August 25, 2014.

22 *Ibid.*

(Lall 2012). This relaxation of Basel III was, however, led mainly by advanced economies rather than emerging economies.²³

The passive involvement of emerging economies in the formation of the new international standards can largely be attributed to their shortage of regulatory expertise, which is in turn affected by their low familiarity with the issues and their small stake in them. The primary goal of the new international standards has been to prevent the recurrence of crises by addressing the main regulatory problems behind the recent crisis, which lay in advanced economies. The new international standards have thus focused on addressing regulatory weaknesses in advanced economies, but many of those problems are not serious or have not even emerged in a number of emerging economies, due to the lower development of their financial markets. This has hindered their regulators' ability to develop the knowledge needed to address these problems.²⁴

Additionally, although a good number of emerging economies did experience serious financial instability during the crisis, the primary source of that instability was not their weak prudential regulations, but the volatility of cross-border capital flows — that is, sudden stops and reversals of capital flows caused by drastic deleveraging in advanced economies. Many emerging economies that had maintained strong economic fundamentals and sound domestic policies were still caught up in the crisis due largely to foreign currency liquidity shortages (in particular, the US dollar) (Kim and Chey 2011).²⁵ Furthermore, after advanced economies adopted large-scale expansionary policies, including quantitative easing in order to boost their economies, large volumes of capital surged back into emerging economies, raising their concerns about financial instability. Emerging economies' regulatory priority in the post-crisis period has thus been to manage capital flow volatility, rather than to strengthen their prudential regulations. Many of them have in fact adopted capital controls, with Brazil having been the first to do so in October 2009.²⁶

It should be stressed, however, that emerging economies have effectively utilized their new SSB memberships to revise

provisions that could have substantial negative impacts on them.²⁷ Despite lacking the abilities to propose a new overall regulatory framework, emerging economies have been able to assess the impacts the regulatory initiatives proposed by advanced economies could have on them. Their new memberships in SSBs have offered them venues in which to effectively interact with advanced economies in establishing international standards, helping them to influence the design of standards.

Emerging economies, many of which rely heavily on international trade, pointed out, for example, that the leverage ratio regulations in the Basel III capital framework would impose excessive costs on trade finance. Also, with regard to the definition of “high-quality liquidity assets” in the Basel III liquidity framework, emerging economies stressed that the availability of those assets was limited in emerging economies due to their low volumes of government bonds, a key component of such assets. In response, the rules governing trade finance were adjusted to prevent an increase in the cost of trade finance, while the definition of high-quality liquidity assets was also modified to include a broader range of assets.²⁸ Although these minor revisions have little effect on the overall Basel III framework, they nevertheless have significantly increased the inclusion of emerging economies' regulatory preferences in that framework. The new SSB memberships of emerging economies in the post-crisis era have clearly had positive effects on their influence in the formation of international standards, compared with the pre-crisis period.

That being said, emerging economies have not always succeeded in incorporating their preferences in international standards, which shows their weak power vis-à-vis advanced economies. Advanced economies have not offered concessions on issues in which they have had a keen interest. One example is the reform of OTC derivatives markets. A number of emerging economies — in particular, those with less-developed derivatives markets — were opposed to the mandatory clearance of standardized contracts through CCPs and the compulsory reporting of contracts to TRs.²⁹ While the risks from OTC derivatives markets were not yet large in emerging economies, the small sizes of these markets would not support the establishment of market infrastructures as local CCPs and TRs, and using the CCPs

23 Lall (2012) attributes the relaxation of Basel III to the opposition from global financial institutions to tighter regulation, but Drezner (2014, 94–99) argues that they were largely the independent decisions of regulators.

24 Author interviews with emerging economy regulators, August 21 and 25, 2014.

25 More than 20 emerging economies ended up as innocent bystanders victimized by the crisis (Bi and Lanau 2011). Three emerging economy members of the G20 — Brazil, Korea and Mexico — obtained dollar liquidity through currency swaps with the US Federal Reserve, which played a key role in helping to stabilize their financial markets, while a request for such a currency swap by Indonesia, another G20 member, was rejected by the Fed (Chey 2013).

26 Other countries that have adopted capital controls since the crisis include Argentina, China, Costa Rica, Ecuador, Iceland, Indonesia, Korea, Peru, the Philippines, South Africa, Taiwan, Thailand, Uruguay, Ukraine and Venezuela. For details on the measures adopted by these countries, see IMF (2011b; 2012: 41) and Grabel (2015, 14–15).

27 Author interviews with emerging economy regulators, August 20 and 21, 2014.

28 Author interviews with emerging economy regulators, August 20 and 25, 2014. In fact, some advanced economies such as Australia were in agreement with emerging economies regarding those issues (I owe this point to Andrew Walter), and they may have helped emerging economies to revise those provisions. This is not to deny, however, that emerging economies have seen increased opportunity to incorporate their own preferences in the international financial standards.

29 Korea, meanwhile, whose financial markets are more developed than those of many other emerging economies, has supported the regulation (author interview with an emerging economy regulator, August 22, 2014).

and TRs in advanced economies could cause disadvantages to emerging economy financial institutions.³⁰ Moreover, unlike in advanced economies, OTC derivatives markets do actually need to develop further in emerging economies and stringent regulation of them might stifle their development.³¹

The United States, however, the primary source of the recent crisis, had a keen interest in strengthening the regulation of derivatives trading, which had been indicated as one of the major causes of the crisis, and even threatened to deny access to its markets to financial institutions not complying with its rules. Domestic demand that OTC derivatives markets be strengthened was also high in European countries (Helleiner 2014, 111). In the face of the strong will of advanced economies to tighten regulation of the markets, the concerns of emerging economies, with their limited resources for influencing international negotiations, have not been appropriately reflected in the OTC derivatives market reforms.

Enhanced Incentives to Comply

Meanwhile, the new SSB memberships of emerging economies appear to have had positive effects on their compliance with international financial standards — by increasing their exposure to external compliance pressures due to the monitoring of implementation and compliance by the SSBs, and also sometimes by strengthening the compatibility between their own regulatory preferences and the standards. Given that most of the new international standards have long implementation periods, and that the implementations of many of them have not even begun yet or are in the early stages, it may at present (as of December 2014) actually be too early for any firm assessment. Moreover, besides SSB membership, compliance with international standards can be affected by a diversity of factors, including the compliance costs.³² Nevertheless, there is some preliminary evidence suggesting extending SSB membership to emerging economies may have positive impacts on their standards compliance.

According to a recent report by the FSB (2014a: 3), the overall progress in implementing the Basel III capital and liquidity framework has been greater in emerging economies with membership in the BCBS/FSB than in those without, and the former group's implementations have been generally proceeding in accordance with the internationally agreed upon time frames. The October 2014 BCBS progress report on Basel

III (BCBS 2014) also found the implementations of the Basel III risk-based capital requirements to have been fairly good in most emerging economy members of the BCBS; adoption of the requirements was partially incomplete in only two of them (Mexico and Russia). Moreover, the BCBS found that the capital regulations of China and Brazil — the only two BCBS emerging economies to have undergone its Regulatory Consistency Assessment Programme (RCAP) to date — were closely aligned with the international Basel III standards, albeit with a few deviations, and assessed both countries as “compliant” overall (BCBS 2013a; 2013b). In addition, with regard to the OTC derivatives market reforms, the FSB reported that emerging economy members of the FSB were implementing them, while the large majority of emerging economies outside the FSB were not (FSB 2014a, 6-7).

Given that the financial sectors in many emerging economies have not been directly hit by the recent crisis, irrespective of their memberships in SSBs, the costs of compliance with international standards such as Basel III in SSB emerging economies, might not differ considerably from those in non-SSB ones. It is thus quite likely that the better implementation of the international financial standards in SSB emerging economies than in non-SSB members reflects the positive effects of the former's new SSB memberships on their compliance.

The greater implementation by SSB emerging economies, in turn, appears to be at least partly attributable to the monitoring of their members by SSBs. Prior to the crisis, SSBs had not conducted systematic monitoring of their members' compliance with international standards.³³ But despite their lack of power to enforce compliance, SSBs' monitoring activities have been significantly augmented since the crisis, with the FSB, in collaboration with other SSBs, playing the central role. The FSB, for example, conducts intensive monitoring and publishes periodic progress reports on the implementation statuses of its members in “priority areas,” which include Basel III, the OTC derivatives market reforms, compensation practices, resolution regimes, policy measures for SIFIs and shadow banking. It also undertakes monitoring of implementation in other areas, based on the survey responses of member countries.

The FSB also carries out regular peer reviews, consisting of thematic reviews and country reviews, and publishes their outcomes. FSB members are, moreover, committed to undergoing Financial Sector Assessment Programs every five years, and to agreeing to the publication of the detailed assessments as bases for their reports on the observance of

30 Author interview with an emerging economy regulator, August 20, 2014.

31 Author interviews with emerging economy regulators, August 20 and 21, 2014. Emerging economies have also been reluctant to adopt tight regulations on shadow banking, given its important role in the provision of small-loan finance.

32 See Chey (2014) for the factors that can affect compliance with international financial standards.

33 In the pre-crisis period, the lead role for promoting compliance with international financial standards was assigned largely to the IMF and the World Bank, which conducted the Financial Sector Assessment Program and published reports on the observance of standards and codes. Countries' participation in these programs was voluntary, however, and they could block publication of their results. Before the crisis, a number of countries, including the United States, China, Indonesia and Argentina, had in fact refused to undergo the assessment program (Helleiner 2014, 131-43).

standards and codes. Additionally, in order to facilitate Basel III implementation, the BCBS has adopted the RCAP, which not only monitors the timely adoption of Basel III, but also assesses the consistency and completeness of the adopted standards, including the significance of any deviations in regulatory frameworks. Similar to the FSB peer reviews, the BCBS assessment program is carried out on both a thematic and a jurisdictional basis.

Indeed, emerging economy regulators have commented that they take into serious account the monitoring activities by the SSBs, as these have increased their exposure to both peer group and market compliance pressures.³⁴ This research discussed in this paper does not consider the independent effects on compliance of each of the various types of external compliance pressures discussed in an earlier section, due partly to a lack of the necessary data. It nevertheless provides at least some preliminary evidence of an overall increase in external compliance pressures on SSB member countries due to the enhanced monitoring.

There is also preliminary evidence showing stronger compliance by SSB emerging economies with international financial standards in which their preferences have been better incorporated, in other words, those with which their own preferences are more compatible. For example, although as mentioned above, the implementations by FSB emerging economies of the OTC derivatives market reforms have been better than those by non-FSB members, they have been notably slower than the implementations by BCBS/FSB emerging economies of the Basel III risk-based capital requirements. In contrast to the great progress by BCBS/FSB emerging economies in implementing the Basel III risk-based capital requirements, which began in 2013, five of these countries have taken no action at all to date related to the requirement of adopting central clearing, which was due to be fully implemented by end-2012 (FSB 2014b). As analyzed earlier, the inclusion of emerging economies' regulatory preferences appears to be greater in Basel III than in the OTC derivatives market reform. This may suggest greater compatibility of emerging economies' regulatory preferences with the former than with the latter.

A comparison between the implementation of Basel III and of Basel 2.5 by emerging economies also appears to show their stronger compliance with international standards that better reflect their own preferences. Basel 2.5, an amendment of Basel II, the predecessor of Basel III, was originally published for public consultation in January 2009, and was finalized in July of that year, while the extension of the BCBS membership to emerging economies took place in June 2009. Emerging economies' joining of the BCBS was, thus, too late to enable them to effectively reflect their preferences in the Basel 2.5 framework. BCBS emerging economies' implementations of

Basel 2.5 have indeed been worse than their implementations of Basel III, which are, as discussed above, incomplete in only Mexico and Russia. Although Basel 2.5 was scheduled to be fully implemented by end-2010, there are four emerging economy BCBS members that have still not completed implementation, whereas all advanced economy members have done so (BCBS 2014).

Conclusion

The rise in status for major emerging economies from mere rule takers to formal rule makers in the wake of the global financial crisis has been one of the most noteworthy changes in post-crisis global financial governance. This paper has analyzed how this change has actually affected international financial regulation, by addressing its impacts on the establishment of, and compliance with, international financial standards. Its findings offer an alternative, and also more positive, perspective to those predominant in the literature — the weakening cooperative view and the enduring status quo view.

The extension of SSB memberships to emerging economies has provided effective venues enabling these countries to raise their voices in the rule-making process related to international financial standards. However, their participation in the process has been largely defensive in form, as emerging economies have concentrated on mitigating the negative impacts of international standards on them. The development of international standards has still been led mainly by advanced economies. Emerging economies' passiveness has been due primarily to their lack of regulatory expertise, a structural problem stemming from the gap in the levels of financial market development between advanced and emerging economies. In addition, emerging economies' ability to reflect their preferences in the construction of international financial standards has been constrained due to their limited resources. Advanced economies' decisions on whether or not to accept demands from emerging economies have depended, ultimately, on their own willingness, and they have tended to accept such demands only when doing so will not be costly to them.

Meanwhile, the new SSB memberships of emerging economies have had positive effects on their compliance with international financial standards through two distinct channels. One channel is the reinforcement of external compliance pressures through the monitoring by SSBs of their members' implementation of and compliance with standards. The other is the enhancement of compatibility between emerging economies' regulatory preferences and international standards. Where emerging economy SSB members have actually been able to incorporate their preferences into international standards, their compatibility with the standards has increased, thereby enhancing their incentives to comply with them.

34 Author interviews with emerging economy regulators, August 20, 21 and 22, 2014.

These findings suggest that the institutional inclusion of emerging economies in global financial governance as formal rule makers is likely to strengthen, rather than hinder, international cooperation on financial regulation. One salient question that follows is how the actual level of emerging economies' participation in the formation of international financial standards is to be increased, something that requires the strengthening of their regulatory expertise. Given that their weak regulatory expertise is a structural problem, emerging largely from the gaps in financial market development between them and advanced economies, it may not be easy to solve this problem in a short time. Nonetheless, capacity-building assistance for emerging economies can help in its mitigation.

One may be concerned, as the weakening cooperation view argues, that emerging economies may have preferences distinct from those of advanced economies, making it more difficult to reach international agreements. As this paper has shown, however, the regulatory preferences of emerging economies do not significantly conflict with those of advanced economies in terms of overall frameworks, although they do differ somewhat with regard to specific provisions. Indeed, although the recent crisis broke out in advanced economies, many emerging economies — in particular those with relatively more developed financial markets — still tend to perceive the regulatory practices in advanced economies as more advanced than their own domestic practices and, accordingly, to feel there are strong incentives for learning and emulating them, especially in the long run.³⁵ It is possible that the inclusion of emerging economies at the head table of international financial standards negotiations may make these negotiations a bit more complicated, but it will not necessarily make them impossible. And such hassles appear to be necessary, or even desirable, if global financial governance is to be strengthened and given greater legitimacy.

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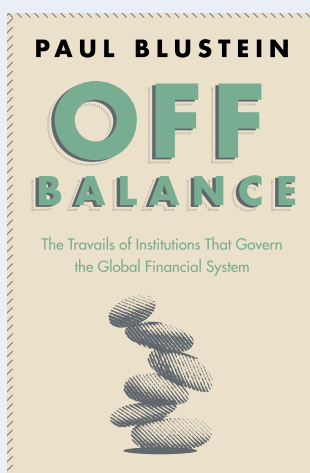
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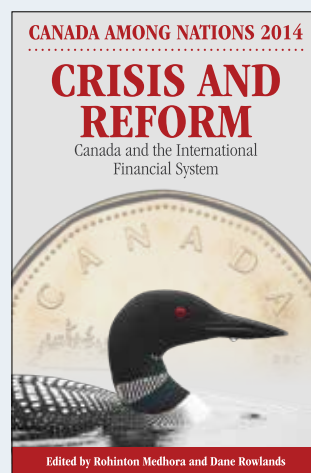
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The China (Shanghai) Pilot Free Trade Zone (SPFTZ), founded in September 2013, has promised liberalization on capital account and trade facilitation as its main objectives. This paper discusses reasons why China needs such a pilot zone after three decades of economic development, examines the differences between the SPFTZ and other free trade zones and highlights the developments of the SPFTZ since its inception. The hope is that the success of the SPFTZ will give rise to a more balanced Chinese economy in the following decade.



Sovereign Bond Contract Reform: Implementing the New ICMA *Pari Passu* and Collective Action Clauses

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The International Capital Market Association (ICMA) has recently published proposed standard terms for new, aggregated collective action clauses. Concurrently, the ICMA released new model wording for the *pari passu* clause typically included in international sovereign bond contracts. These announcements and the commencement of issuance of bonds with these clauses are an important turning point in the evolution of sovereign bond markets.



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Since China's pilot scheme for RMB cross-border settlement was launched in 2009, it has become increasingly important for monetary authorities in terms of macroeconomic policy frameworks. The authors use an analytical model that includes monetary supply and demand to examine the influences of RMB cross-border settlement on China's domestic interest rate, asset price and foreign exchange reserves. They also look at how RMB settlement behaves in different ways with the various items in China's balance of payments.



Completing the G20's Program to Reform Global Financial Regulation

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Malcolm D. Knight

The measures regulators have largely agreed on for a strengthened and internationally harmonized financial regulatory regime, which were endorsed at the 2014 G20 leaders summit in Brisbane, are a major step toward achieving a robust and less crisis-prone global financial system. There are, however, a number of specific measures that need to receive closer attention in order for the G20 leaders to declare their reform program a success. This paper discusses what policy makers and regulators should focus on in 2015 and why closer international cooperation in implementing regulatory reforms will be essential for success.



The Risk of OTC Derivatives: Canadian Lessons for Europe and the G20

CIGI Papers No. 57
Chiara Oldani

Over-the-counter (OTC) derivatives played an important role in the buildup of systemic risk in financial markets before 2007 and in spreading volatility throughout global financial markets during the crisis. In recognition of the financial and economic benefits of derivatives products, the G20 moved to regulate the use of OTC derivatives. Attention has been drawn to the detrimental effects of the United States and the European Union to coordinate OTC reform, but this overlooks an important aspect of the post-crisis process: the exemption of non-financial operators from OTC derivative regulatory requirements.



The Trade in Services Agreement: Plurilateral Progress or Game-changing Gamble?

CIGI Papers No. 53
Patricia M. Goff

Trade analysis in the current moment is understandably focused on mega-regional negotiations, but plurilateral talks also deserve our attention. Plurilateral negotiations leading to a Trade in Services Agreement (TiSA) is the focus of this paper. Barriers to trade in services are distinct and their removal consequential; thus inviting careful consideration and, ideally, public debate. This paper seeks to illuminate developments in negotiations toward the plurilateral TiSA. Just as it has become commonplace to ask whether regional agreements advance economic and political agendas, so is it useful to explore the promise and peril of plurilateral agreements such as TiSA.

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Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

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