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The Global Capital Market Reconsidered

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Abstract

While the globalization of production has been a prominent target of anti-globalization backlash, globalized finance has seemed to be much less in the public bull's-eye. The blueprint for the postwar international economy agreed at Bretton Woods in 1944 envisioned nothing like today's extensive and fluid global capital market. The demise of the 1946-1973 fixed exchange rate system, however, also brought a progressive dismantling of barriers to international financial flows motivated by special-interest politics, national economic competition, and ideology – alongside the benign desire for a more efficient international allocation of capital. Unfortunately, free cross-border financial capital mobility can compromise governments' capacities to attain domestic economic and social goals in several ways. This essay links the dynamics of financial liberalization to the Teflon-like resilience of finance to backlash so far, and suggests that stronger backlash could emerge if national governments fail to enhance multilateral cooperation to manage the financial commons.

JEL Classification: E52, F02, F21, F30, F65, O19

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The resurgence of domestic and international finance over the past five decades was neither planned nor foreseen by economic policymakers at the end of World War II. While the globalization of production has been a prominent target of anti-globalization backlash, especially in the United States, globalized finance has seemed to be much less in the public bull's-eye. This is true notwithstanding its essential role in the great 2007-08 financial crisis and other crises that have had long-lived negative economic effects. Overall, however, prevalent attitudes about finance remain neutral compared with public reactions during the Great Depression of the 1930s. That experience shaped much of government policy toward the financial sector in the quarter century after World War II, particularly the global community's initial postwar policy stance toward private international financial transactions. But things have changed. Within the high-income countries that account for the bulk of global capital market activity, earlier official skepticism toward unfettered international finance is long gone.

General dissatisfaction with capitalism as practiced today has risen since the great financial crisis – the reasons include adverse trends in income distribution, market power, economic growth, and environmental degradation – but public debate has yet to focus sufficiently on the role of globally footloose money. This comparative neglect is puzzling because international financial activity, despite providing important economic benefits, extends far beyond the point where net social benefits are maximized and reaches into areas likely to prove counterproductive. In particular, financial globalization is a potential conduit through which national efforts to reform domestic capitalism may be frustrated. The fundamental reason is that the scope of international financial markets far exceeds the limits of any one national sovereignty, undermining nation-level levers for influencing market outcomes and thereby reaching domestic policy objectives.

Hoping to illuminate the role of modern global finance, this essay addresses three basic questions:

- What explains the evolution of trans-national financial markets over the past 50 years? My answer focuses on the policy tradeoffs governments have faced, the growing political clout of the finance industry, and ideology.
- Where does global finance capitalism most challenge national policymakers and the international community? Prime challenges reside in the areas of financial stability; tax competition, avoidance, and evasion; and facilitation of corruption. I will focus on the first of these.
- What explains the Teflon-like resilience of financial globalization to the popular backlash against production globalization that now prevails in U.S. politics, notwithstanding the recent Global Financial Crisis? I will suggest that different political dynamics apply to trade and finance, while admitting that this hypothesis leaves important unanswered questions.

Each of these areas deserves a much more thorough treatment than it will receive, so my proposed narrative is necessarily terse, incomplete, and tentative. Nonetheless, in an era where trade and outsourcing have captured the political spotlight, I believe that it is useful to begin drawing the role of finance out of the shadows.

We cannot return to the financial environment of 1945 – nor should we wish too – but we can find a better balance between financial license and governments' legitimate desires to achieve domestic policy goals. I will argue that national measures coupled with more effective intergovernmental cooperation can enhance domestic policy space without materially compromising gains from financial integration.

The Post-1945 Economic Settlement

In the decade between the Versailles conference of 1919 and the financial crash of 1929, national political elites in the victorious countries tried to restore pre-war world economic arrangements that, even before 1914, had been fraying. Assessing that effort in 1933, John Maynard Keynes drily observed, “The decadent international but individualistic capitalism, in the hands of which we found ourselves after the war, is not a success” (Keynes 1933, p. 183).

The international economic settlement that the victorious Allied powers envisioned at the end of World War II differed from the Versailles settlement, which implicitly assumed a return to free trade and payments, based on the gold standard (Eichengreen 2019, p. 7). Instead, the post-1945 settlement rested on a foundation of what John Ruggie (1982) famously called “embedded liberalism”: a politico-economic framework in which political authority would have a legitimate and central role in mediating the relationship between the market and society. As Ruggie (p. 393) put it:

Liberal internationalist orthodoxy, most prominent in New York financial circles, proposed to reform the old order simply by shifting its locus from the pound to the dollar and by ending discriminatory trade and exchange practices. Opposition to economic liberalism, nearly universal outside the United States, differed in substance and intensity depending upon whether it came from the Left, Right, or Center, but was united in its rejection of unimpeded multilateralism. The task of postwar institutional reconstruction ... was to maneuver between these two extremes and to devise a framework which would safeguard and even aid the quest for domestic stability without, at the same time, triggering the mutually destructive external consequences that had plagued the interwar period. This was the essence of the embedded liberalism compromise: unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism.

The central element of the post-World War II framework was the Bretton Woods agreement, negotiated mainly between the United States and the United Kingdom and finalized in 1944. It was a compromise within a compromise. Its foundational compromise between market and state contained another one between a U.S. Treasury team led by Harry Dexter White, which sought to promote American economic interests and hegemony, and a U.K. Treasury team led by Keynes, which sought to protect Britain’s position and influence through a more symmetrical global distribution of economic power.¹

¹ That the United States would push for a postwar settlement based on embedded rather than a more classical international liberalism was not preordained. Within the U.S. government, the Department of State favored trade arrangements that would restore laissez-faire in international trade, whereas the U.S. Treasury succeeded in shifting the locus of negotiations to international monetary arrangements and thereby took the dominant role in U.S. postwar planning. Monetary policy was “a less contentious issue, and agreement was eventually reached, undercutting the U.S. State Department’s more conventional but also controversial free trade position” (Ikenberry 1992, p. 292). (Trade issues thus were left for the subsequent Havana Charter of 1948, which led to the GATT.) Ikenberry (*ibid.*) explains how the Bretton Woods agreement captured a broader social consensus in favor of embedded liberalism:

What ultimately mattered in the ratification of the Bretton Woods agreement was not that it was based on the policy ideas advanced by an expert community but, rather, that the policy ideas resonated with the larger political environment. The ideas of the experts ultimately carried the day because they created the

The blueprint for the new International Monetary Fund (IMF) contained five critical ingredients:

1. An ambition to return to general currency convertibility for the purpose of current account transactions – a necessary requirement for restoring a multilateral trade system consistent with an efficient international allocation of productive factors.
2. Official multilateral funding (through the IMF) for short-term balance of payments gaps.
3. Exchange rates pegged to the U.S. dollar (which in turn was convertible for gold at a fixed price by official dollar holders).²
4. The possibility to devalue or revalue currencies in the face of persistent payments imbalances (so-called “fundamental disequilibrium”).
5. A presumption that countries could and in some cases should restrict private international financial transactions.³

The final ingredient above was necessary to give countries some degree of monetary policy autonomy for managing the domestic economy. Otherwise, the open-economy monetary trilemma would dictate that with international capital mobility and fixed exchange rates, IMF members would have no leeway to move domestic interest rates away from U.S. levels (Obstfeld and Taylor 1998).⁴ In addition, without constraints on private capital movement, the “fundamental disequilibrium” option of a possible exchange parity change could become a huge destabilizing force, potentially setting off uncontrollable speculative capital flows across borders. Thus, the embedded liberalism compromise aimed for a system in which episodic exchange-rate changes could adjust countries’ balance of payments positions to the needs of the domestic economy, rather than the domestic economy adjusting to balance of payments constraints as had been the case under the gold standard. The compromise also might facilitate government policy more broadly construed. Harry Dexter White argued that governments needed the tools to prevent capital flight motivated by aversion to “the burdens of social legislation” (Helleiner 1995, p. 318). Overall, the goal of embedded liberalism was to create “a form of multilateralism that is compatible with the requirements of domestic stability” (Ruggie 1982, p. 399).

conditions for larger political coalitions within and between governments – coalitions which themselves reflected a more general postwar reworking of the sociopolitical order in Western capitalist democracies.

Even so, the British conception of its postwar domestic policy framework (as outlined in the 1942 Beveridge report) envisioned a more fulsome welfare state than the U.S. political establishment was then prepared to accept.

² Ruggie (1982, p. 406) asserts that the U.S. Treasury inserted the U.S. dollar’s key currency status into the Bretton Woods agreement without Keynes’s knowledge.

³ Article VI, section 3, of the IMF Articles of Agreement states:

Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments [with two technical exceptions].

⁴ The monetary trilemma holds that only two of the following three can be mutually compatible: monetary policy geared toward domestic objectives, a fixed exchange rate, and internationally open capital markets.

Financial Leakages and the Collapse of Pegged Exchange Rates

Sealing off the economy from international financial flows proved to be difficult – and the system ultimately allowed too much leakage for the pegged-but-adjustable exchange rate system to survive. The main European currencies became externally convertible (for current account transactions) at the end of 1958. The subsequent growth of global trade, while fulfilling one of the main goals of the Bretton Woods architects, provided many opportunities for disguised cross-border capital movements (for example, through leads and lags in trade-related payments). Furthermore, as U.S. multinationals expanded their operations during the 1960s, their demand for financial services outside the U.S. led to a large expansion in American banks' overseas branches. As early as 1961, speculative money inflows into Germany (which had gone farther than other European countries in opening its financial account) forced a revaluation of its currency. The Dutch also revalued, and Switzerland came under revaluation pressure. The year 1964 saw the start of the protracted sterling crisis that would lead to devaluation in 1967.

There were two other destabilizing factors at work: the growth of an offshore currency market in London and U.S. inflation.

The unregulated Eurodollar market (where international banks traded U.S. dollar deposits) emerged in London in the late 1950s. As Helleiner (1995, p. 320) observes

Although this “offshore” activity remained strictly segmented from national financial systems, it still represented the most liberal international financial environment that market actors had experienced in several decades and they quickly took advantage of it.

U.K. and U.S. authorities not only tolerated but also promoted the market. While maintaining a strict cordon around its domestic banking system, the British government hoped to enhance its banks' international business opportunities, thereby recapturing some of London's historical role as a global financial hub. The United States had its own motivations. The U.S. Interest Equalization Tax of 1963 aimed to strengthen the U.S. balance of payments by taxing capital outflows, but also made it more expensive for U.S.-based banks to lend directly to multinationals abroad. Responding to pressures from banks and industry, the U.S. allowed and even encouraged U.S. banks to set up shop in London. At the same time, the Eurodollar market raised the international liquidity of the dollar and made it more attractive for foreign residents to hold – another plus from the standpoint of the worrisome U.S. balance of payments (Helleiner 1995, pp. 320-321), and one from which U.S. policymakers hoped to benefit. However, the offshore market ultimately provided another venue for speculation against the U.S. dollar.

Inflation was the second destabilizing factor. It accelerated in the United States in the latter 1960s as the Federal Reserve kept interest rates relatively low in the face of increasing fiscal pressures from the Vietnam War and President Lyndon B. Johnson's Great Society programs. Under the pegged exchange rate system, this inflation spilled over to the rest of the world, even more so as inflationary pressures accelerated under the subsequent presidency of Richard M. Nixon. Inflation interacted with pre-existing distortions in the financial sector to raise pressures for financial liberalization. In the United States, the Depression-era Regulation Q limited the interest banks could offer for onshore deposits, driving them offshore for wholesale funding. With deposit rates capped, mounting U.S. inflation also implied that the real interest rates depositors could earn were becoming increasingly negative. Financial activity moved to commercial paper markets and new money-market mutual funds, and as a result, pressures for bank deregulation grew in the United States as well as in other industrial countries.

Both rising U.S. inflation and the ongoing U.S. external payments deficit eventually led to uncontrollable speculation against the dollar. After vain attempts to stem the tide, industrial countries allowed their exchange rates to float. By March 1973 the Bretton Woods network of dollar pegs was gone. What at the time seemed like a temporary retreat from pegging turned out to be permanent, as the floating rate system remains in place nearly 50 years later and indeed, has expanded to include most of the major emerging market economies (China being a notable exception).

It is worth taking a moment to consider how exchange-rate flexibility fit in with prevailing economic theories at the time, because it was within a flexible-rate world that international financial transactions ultimately were freed. In fact, economists' views did not correlate well with their views on the state's social role in the economy. In the interwar period, Friedrich Hayek (1937) saw departure from the gold standard as a symptom of a dangerous monetary policy nationalism that would fragment markets, encourage governments to undertake dangerous social projects, and undermine global property rights and international law. In contrast, Milton Friedman (1953), while sharing Hayek's opposition to socially activist governments, saw flexible exchange rates as advantageous nonetheless because they would reduce the government incentives to restrict international trade and payments – incentives all too evident at the time Friedman wrote. James E. Meade's (1955) advocacy of floating rates shared Friedman's aversion to trade restrictions, but also featured a strong call for national monetary and budgetary autonomy. Harry G. Johnson (1969), though generally closer to Friedman ideologically, was not a monetarist, placed more weight on combating unemployment, and viewed floating rates as promoting policy autonomy as well as freedom of payments. But Charles Kindleberger (1970), a Keynesian in his general policy orientation, thought that a move to generalized floating would fail to yield the promised benefits in terms of policy autonomy, while inflicting collateral costs.

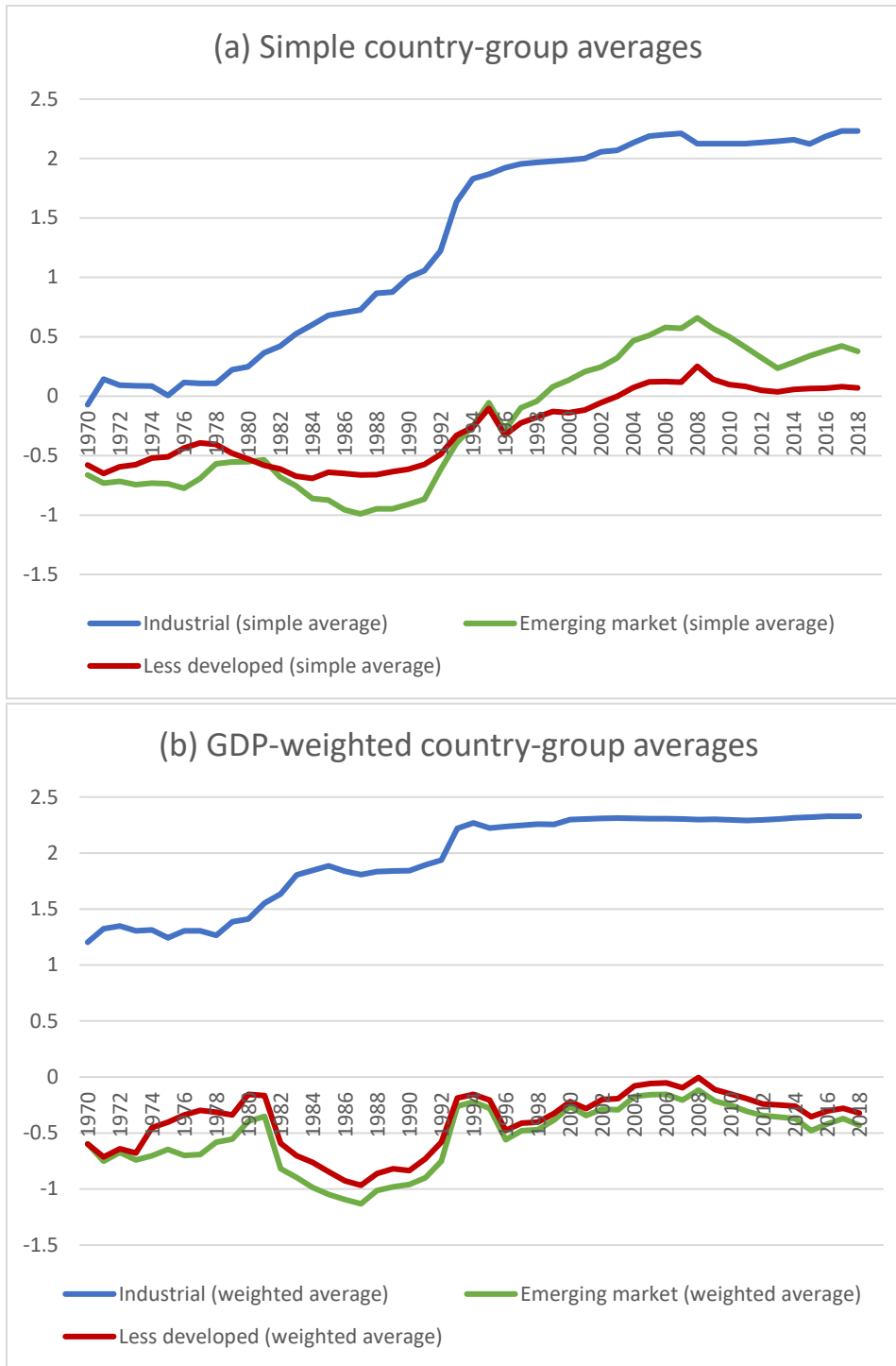
Friedman's logic, based on the trilemma, yielded an accurate prediction: Freed from the constraint of pegged exchange rates, policymakers had less need to restrict international payments to achieve monetary policy autonomy. They could liberalize international financial flows while still enjoying freedom of action on interest rates. This observation, however, does not explain *why* they did so (Obstfeld and Taylor 2017), in a protracted process that began in the early 1970s and has ultimately moved the world far from the embedded liberalism that underlay the immediate postwar decades.

The Great Liberalization

The financial account liberalization process for industrial economies began immediately after the move to floating exchange rates. In less affluent countries, the process began later and has not gone as far. The updated index of capital account liberalization developed by Chinn and Ito (2006), shown in Figure 1 for industrial, emerging, and less developed countries, conveys the timing and extent of liberalization in the different country groups.⁵

⁵ In Figure 1, the simple averages in panel (a) and the GDP-weighted averages in panel (b) tell similar qualitative stories. Quantitatively, panel (a) obscures how relatively open the bigger industrial economies were in 1970, because it gives equal weight to relatively closed smaller economies like Greece, Iceland, Malta, and Portugal. At the same time, panel (b) understates the number of emerging economies liberalizing after the mid-1990s by giving higher weight to countries that did not liberalize as much, such as Brazil, China, and India.

Figure 1 Index of Capital Account Openness, 1970-2018



Source: Chinn and Ito (2006) de jure index updated to July 13, 2020, URL: http://web.pdx.edu/~ito/Chinn-Ito_website.htm. The index ranges from -1.92 (most closed) to 2.33 (most open). The figure shows both simple unweighted averages over countries [panel (a)] and averages weighted by GDP shares evaluated at market exchange rates [panel (b)]. China enters the index in 1984. Russia and other former Soviet states enter in 1996.

The economic case for liberalizing financial flows rests on two main pillars. First, cross-border financial controls are difficult to enforce and enforcement efforts can entail escalating distortions, including opportunities for rent seeking and corruption. Second, there is the promise of the classical gains from trade: from efficient international risk sharing, capital transfer, and liquidity provision.⁶ But international financial flows can entail drawbacks, too, as I detail further below. Moreover, the prospect of *aggregate* efficiency gains is rarely determinative in reality – what matters is the balance of political power of the interests that benefit or lose from liberalization. So what forces drove the post-1973 process of global liberalization? While it is artificial not to treat cross-border liberalization as integrally connected to *domestic* liberalization (and I will not ignore domestic liberalization completely), I nonetheless focus on a few key trends that specifically promoted freer international flows.

A strong initial impetus toward open capital accounts among the industrial countries came from the United States. The fixed exchange rate system might have been preserved through a cooperative international system of capital controls, as Japan and European countries proposed in 1973, but the United States strongly opposed these and, moreover, announced that its own controls would be abolished the following year (Helleiner 1995, pp. 322-323). These moves channeled a generally free-market bent within the Nixon administration, associated with both high-level officials (such as George Shultz at Treasury and Herbert Stein at the Council of Economic Advisers) and outside counselors (such as Friedman and Alan Greenspan). That tendency would come to dominate economic policy in the Reagan years. But the U.S. desire to see international financial controls dismantled also reflected ambitions to cement further the U.S. position as the leading global financial center and to let the dollar weaken in foreign exchange markets.

The United States' deregulation offensive gathered force in the 1980s under the Reagan administration. Ideology was buttressed by the more pragmatic desire to ease the foreign financing of historically big U.S. current account deficits. Toward that end, the U.S. pressured Japan to liberalize its financial markets (Frankel 1984). Somewhat ironically, the drive to lure Japan's copious saving to the United States fueled two types of nationalist backlash: resentment against Japanese purchases of some iconic assets (Firestone, Columbia Pictures, Rockefeller Center) and trade dislocations that triggered protectionist U.S. government reactions (the accounting counterpart of a bigger U.S. financial inflow surplus would inescapably be a larger U.S. current account deficit). The global capital market deepened over the next two decades, allowing the U.S. external deficits that preceded the global financial crisis to dwarf those of the Reagan era (Chinn and Frieden 2011).

Financial liberalization has a *snowball effect*, in that it enriches some elements of society (in this case financial firms and multinationals), who use their financial clout to steer the political process away from potential re-regulation and toward further relaxation. In turn, success in these lobbying efforts enriches the beneficiaries further, allowing them to extend their political gains. Writers as diverse as Krippner (2011) and Greenwood and Scharfstein (2013) have chronicled the growing financialization of the U.S. economy over the postwar period. Similar trends appear in data for Canada, Japan, the United Kingdom,

⁶ There is also the argument that financial openness can discipline governments that otherwise would pursue rash policies. But what is "rash" is in the eyes of the beholder, and some would view the "disciplining" effect of capital flows as a negative (as in Harry Dexter White's comment above). Others would argue that the alleged "disciplining" function rarely overcomes political imperatives, and only makes the crash come sooner and harder.

and several continental European countries (Philippon and Reshef 2013). It is therefore no surprise that the liberalizing trends gained momentum in advanced economies over the 1980s.

Financial liberalization also has had a *competitive effect* globally, as financial and industrial elites outside the United States have pressured their governments to liberalize in order to compete for global market share with U.S. banks and non-banks, as well as with other liberalizing countries. Having promoted the Eurodollar market as a way maintain its traditional position in banking and securities trade, the United Kingdom in 1979 eliminated capital controls dating back to the 1940s and in 1986 deregulated the London Stock Exchange in a “Big Bang.” Financial liberalization on the European continent during the 1980s, in particular the dismantling of capital controls by the end of that decade, was motivated by a desire for closer economic union, but also by local pressures to be more competitive with Anglo-American finance. The euro project addressed the monetary trilemma by creating a single area-wide currency – thereby abolishing internal exchange rates.

I have noted a role for ideology in these developments. That role should not be understated. Disillusion in the 1970s with slower growth, higher inflation, and in many countries, industrial unrest, helped fuel the spread of neoliberal approaches to economic policy that glorified free-market outcomes and by implication rejected what Ruggie (1982, p. 382) refers to as “legitimate social purpose” in policy or policy regime design.⁷ This development was of central importance in providing not just an intellectual framework that beneficiaries of financial liberalization used to promote and justify their advocacy, but also one that those who wished to deconstruct aspects of embedded liberalism even beyond the financial sphere could weaponize.

Building on ideas like those of Hayek and Friedman, the neoliberal school, with intellectual roots in the interwar period, favored a minimal state devoted above all to safeguarding property rights and the primacy of the market as the ultimate arbiter of resource allocation. Neoliberals naturally defined the market to be global in scope: by definition, national interventions at the border could only be counter-productive of efficiency, and therefore illegitimate. In Helleiner’s words (1995, p. 324):

[Neoliberals] did not sympathize with the commitment of Keynes and White to national Keynesianism and the autonomy of the welfare state. Instead, they applauded the way international financial markets would discipline government policy and force states to adopt more conservative, “sound” fiscal and monetary programmes.

On this view, the market, not the state, would be master.

Margaret Thatcher and Ronald Reagan were the most prominent political manifestations and sponsors of this worldview. Their impacts on economic policies and politics were consequential and persistent, even inducing leaders of nominally left-wing parties to “triangulate” toward the right during the 1990s. The Soviet bloc’s economic failure and political collapse reinforced the trend. In this environment, industrial countries essentially completed the journey to fully open finance over the 1990s (Figure 1).

⁷ Brown (2019) argues that the neoliberal project essentially denies the legitimacy of “society” as a conceptual category and therefore denies the legitimacy of government policies aiming to manage market outcomes in pursuit of social goals.

Neoliberalism captured economic policymaking earlier in parts of Latin America, where it was associated with radical opening and macro stabilization programs in Argentina, Chile, and Uruguay.⁸ These ended in tears, as Díaz-Alejandro (1985) memorably described in the Chilean case. As the 1980s debt crisis engulfed large parts of the developing world, financial openness, already low, fell further.

But in the 1990s, low- and middle-income countries (LMICs) gradually began to embrace financial liberalization measures, along with a raft of economic reform measures intended to boost growth after the doldrums of the 1980s. These reforms differed from country to country, and different governments took different approaches to external financial liberalization. Figure 1 suggests, however, that a general push toward financial openness started in the early 1990s in many emerging market and less developed economies, with the peak (around the time of the Global Financial Crisis) stopping quite a bit short of what the more affluent economies chose – followed by some retrenchment.

Why did this happen? Again, the answers differ across regions and even across countries within regions, but some common trends stand out. Many countries (albeit in different ways across country groupings) opened up further to international trade. Many also promoted domestic financial development as essential for economic growth. These factors supported external financial liberalization:

A sophisticated, deep financial system is ... hard to insulate from the rest of the world, especially given the reality of growing merchandise trade. Furthermore, opening a closed financial system can, at least in principle, improve its performance ... from importation of foreign best practice, from efficiency-enhancing competitive effects, from expanded diversification opportunities, and through undermining domestic vested interests (enhanced competition in the political arena).⁹

Aside from the desire to make a virtue of necessity and capture these benefits, pressure from domestic financial interests as well as governments' desires to deepen markets for their bonds played roles.

Also important was cheerleading from the international financial community. As Obstfeld and Taylor (2017, pp. 14-15) observe:

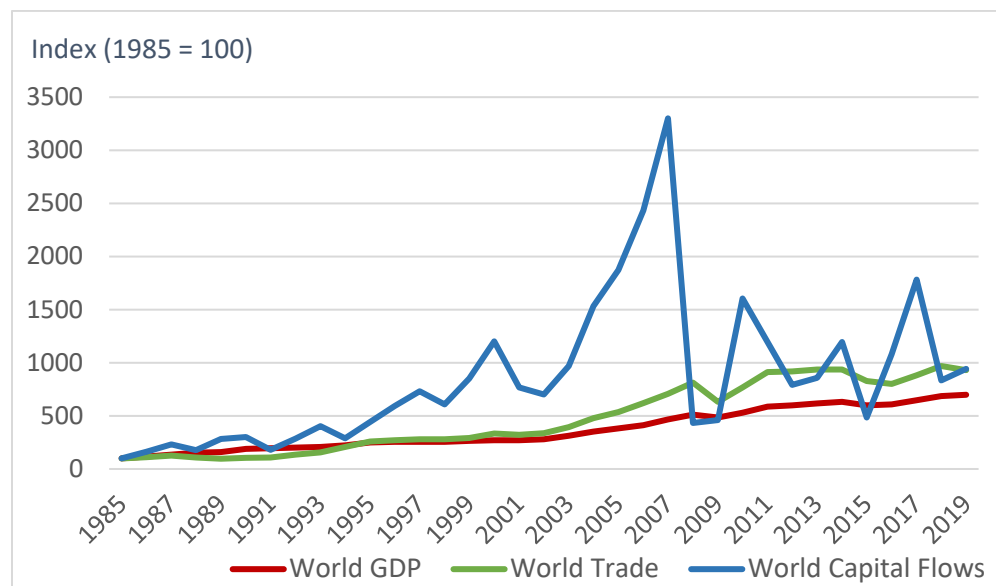
The doctrinal shift regarding capital mobility seen in advanced economies in the 1970s and 1980s began to spread globally in the 1990s. By September 1997, the IMF's management was proposing that the Fund's executive board amend the Articles of Agreement to give the Fund an explicit role in guiding countries toward more open capital accounts. To be clear, the proposal was not advocating an indiscriminate rush toward opening; indeed, it recognized the role of capital inflows in financial crises, such as those that had afflicted Latin America from the mid-1970s through the mid-1990s, and it therefore explicitly sanctioned gradualism, based on country circumstances (Fischer 1997). But it took as a given that an open capital account was the desirable ending point for all countries

Fischer's proposal was more nuanced than much of what had gone before. An assessment by the IMF's Independent Evaluation Office (2005, p. 4) found that through the mid-1990s, the Fund's staff "clearly encouraged capital account liberalization" and seldom stressed the accompanying risks (although the IMF Articles of Agreement precluded *requiring* countries to liberalize – a legacy of embedded liberalism).

⁸ Hayek's ideas had long been influential in the Southern Cone of Latin America; see Ramos (1986, p. 10n).

⁹ Obstfeld (2009).

Figure 2 Comparing the Growth of World GDP, World Trade, and World Capital Flows (nominal U.S. dollars, all series rebased to 1985 = 100)



Source: Trade is sum of world merchandise imports, in U.S. dollars. Capital flows are the sum of world gross inflows, in dollars. World GDP is measured in U.S. dollars at market exchange rates. Only countries with data reaching back to 1985 are included. Data come from United Nations, Comtrade database, and International Monetary Fund, *World Economic Outlook* and *Balance of Payments Statistics*.

In any case, the Asian crisis of 1997-1998 dealt a blow to the IMF’s advocacy of this plan, as well as to any assumption that a fully open capital account is the appropriate end-point for all countries. But for LMICs, capital-account liberalization nonetheless crept ahead as some repaired weaknesses in their financial systems, as many embraced more exchange-rate flexibility better to navigate the trilemma, and as the world entered a period (following the dot.com crash and the 9/11 attack) of buoyant commodity prices and abundant global liquidity (Hume and Sentance 2009). Accommodative global conditions made it hard for governments to resist advocates of financial openness. Even formerly extractive states that Nurkse (1954) believed would never receive private investment flows from abroad gained market access as “frontier” economies. Figure 2 shows the remarkable surge in global capital flows from 1985 through the late 2000s compared with the growth of world GDP and world trade.¹⁰

The Global Financial Crisis of 2007-2008 (closely related to the prior global liquidity surge evident in Figure 2) brought this period of exuberance to a close. Since then, global capital flows have been occasionally very large, but quite volatile. For rich and poor countries alike, the international financial system in its current state looks quite different from what Keynes and White had envisioned at the close of World War II. Fixed exchange rates are largely gone. Governments do pursue countercyclical macroeconomic policies, as the authors of Bretton Woods intended, but generally within real or perceived market constraints that for emerging and developing economies depend heavily on the reactions of global capital markets. Finally, international financial mobility remains extensive and as free of official barriers as it ever has been since World War II. At least as far as finance is concerned, the

¹⁰ The UN Comtrade data track services trade starting in 2000, and in particular, trade in financial services and insurance. The latter category grew faster than overall trade after 2000, but not dramatically so.

international economy has moved on from embedded liberalism toward a system of global capitalism. What challenges does this policy regime pose?

Stability Challenges from Global Financial Capitalism

In democratic societies, national governments cannot ignore voters' legitimate demands for security and prosperity. But the global capital market extends beyond the regulatory and fiscal perimeters of any one country, making it harder for governments to deliver. On the other hand, international market integration yields undeniable aggregate benefits. Because the market spans national jurisdictions, mass democracy and globalization clash in the absence of an all-internalizing global economic policymaker, as Dani Rodrik (2000) has stressed. Tommaso Padoa-Schioppa (2010) captured the essence of the tradeoff that countries face:

The exit from the configuration that led to [the Global Financial Crisis] should be a government which, of course, respects economic freedom, but at the same time exerts its role forcefully and is not prostrate before the twin idols of the market and the nation-state.

The genie unleashed by a half century of global financial development cannot be stuffed back in its bottle. So the best governments can do is to undertake effective domestic regulation while cooperating on their common challenges from financial globalization – preferably, in a way that makes transparent to voters the benefits of a multilateral approach. In so doing, governments can jointly enhance the benefits from the global capital market while reducing its drawbacks. Effective cooperation between sovereign nations, however, is necessarily a dynamic and arduous process that needs to grow as experience reveals previous shortcomings and as new pressure points emerge.

One salient problem area is taxing global profits—where, as in financial deregulation, there has been a competitive race to the bottom that deprives governments of the revenues they need to fund necessary public goods. Another is global tax evasion, money laundering, and corruption, which both large and small financial centers facilitate (Zucman 2015). There are some hopeful signs in these areas. Regarding taxation, the Biden administration's proposal for a 15 percent worldwide minimum corporate profits tax rate (Yellen 2021), in line with the Organisation for Economic Co-operation and Development's (OECD) long-running initiative on Base Erosion and Profit Shifting, has drawn support from a large group of countries including all of the Group of Twenty. Regarding illicit cross-border money flows and corruption, a major development for the United States (and therefore for the world) has been the Corporate Transparency Act included in the U.S. National Defense Authorization Act for 2021, which forces corporations to disclose their actual beneficial owners at the time of formation. Also notable is the Biden administration's publicized recognition of global corruption as a "core United States national security interest" that requires international cooperation to address effectively (White House 2021).¹¹

Here I will focus on another area where multilateral cooperation is much needed, but one in which it has long occurred and continues to evolve: financial stability.

Early in the floating exchange rate period, cross-border fissures in financial regulation emerged, partly related to the risks of exchange rate fluctuations themselves and of counterparty failures across

¹¹ Sutton and Judah (2021) offer a far-reaching proposal that operationalize the Biden administration's stated aspirations on global corruption. Devereux et al. (2021) propose principles for more efficient solutions to the problems of base erosion and profit shifting.

different time zones. In response, eleven countries including the Group of 10 countries established the Basel Committee on Banking Supervision (BCBS) under the auspices of the Bank for International Settlements (BIS). Immediate concerns of the BCBS included the allocation of regulatory responsibilities between the host and parent governments of international banking establishments, as well as necessary informational exchanges between national regulators. Following the developing country debt crisis of the 1980s, which posed threats to capital levels in money-center banks, the BCBS in 1988 issued the first of three accords aimed at setting minimum international capital adequacy standards, while addressing other market risks. These were widely adopted, with the most recent framework, known as Basel III, aimed at repairing deficiencies of its predecessor that became evident in the Global Financial Crisis. In 1999, the Group of Seven industrial countries formed the Financial Stability Forum, also housed at the BIS, to bring together a broader group of national financial officials concerned with a wider range of financial market activity and infrastructure. The Forum became the current Financial Stability Board after the Global Financial Crisis, with an expanded membership.

The work of the BCBS and FSB has reduced the global financial risks posed by regulatory gaps across borders and a race to the bottom in prudential standards. By setting minimum global standards with the aim of enhancing financial stability everywhere, that work has made it easier for countries to attain their own macroeconomic stability goals – while leaving them free, in principle, to mandate stricter standards for domestic activity if they wish. International regulatory cooperation thus stands out as one of the more positive arenas of international policy collaboration.¹² Multilateral work on payments and market infrastructure has also been beneficial, leading, for example, to more efficient settlement of foreign exchange transactions.^{13,14}

This progress owes in part to the highly technical work of the groups, largely escaping the glare of politics (though not the attention of industry lobbyists), as well as an epistemic framework that negotiators broadly share. The framework recognizes that the risks of broad crises in which all countries suffer must limit to some degree the pursuit of national objectives. However, the very successes of the process have promoted the expansion of cross-border financial activity – which otherwise, more countries might have tried to limit. The same applies to the last-resort lending and bailout interventions of central banks and finance ministries in various crises – they are inescapable *ex post*, but *ex ante*, the expectation that they will be forthcoming can encourage higher volumes of cross-border financial activity, and in the worst case, imprudent financial behavior.

While in many ways conducive to financial stability, the process of international collaboration may therefore also accentuate some financial vulnerabilities. In general, financial regulation can become a

¹² For criticism that Basel III standards still permit excessive financial stability risk, see Admati (2016).

¹³ Governments clearly face a commitment problem in standing up to home industry lobbyists pushing for deregulation. This dynamic produces the race to the bottom. Common standards negotiated by regulators (and monitored by the IMF) can better fortify governments to push back. In this case, the resulting shared commitment capability is an important public good, produced by “soft law” rather than treaty law (Brummer 2010). The cooperative process also contributes to the related public goods of global financial stability (because instability in a major market endangers everyone) and smoother international payment, settlement, and clearing systems. The BCBS-FSB example shows how international cooperation can mitigate a domestic dynamic inconsistency problem of government policy, but there could also be settings in which the opposite occurs (for example, Rogoff 1985). Of course, a direct approach to mitigating the dynamic consistency problem at its source would restrain the lobbying power of the financial sector.

¹⁴ Problem areas remain in cross-border payments, however, notably including remittances to poorer countries.

game of whack-a-mole in which well-intentioned actions set in train destabilizing market adaptations that need to be addressed in subsequent rounds of regulation. Indeed, the Global Financial Crisis revealed the potential for national regulatory failures to interact in explosive ways, notwithstanding the prior international coordination process. For example, in the 2000s, U.S. prime money market mutual funds made loans to European banks, which recycled the funds back to the United States to purchase subprime-linked assets (Acharya and Schnabl 2010; Bernanke et al. 2011; Bayoumi 2017). In the years following the crisis, national actions supplemented international reforms, for example, Dodd-Frank and the prime money market mutual fund reform in the United States, as well as the redesign of the euro area’s regulatory framework for banking. All of these measures seem to have strengthened global financial resiliency on balance, but they have had some unintended consequences, and in any case markets will adapt further – in analogy to the evolution of viral variants that may evade vaccines. Sustained vigilance is in order.¹⁵

In the United States, the Trump administration weakened several aspects of Dodd-Frank, such as the Volcker rule. Overall, however, the United States remained engaged with the process of international regulatory collaboration throughout the Trump presidency – unlike with other aspects of international cooperation, such as climate and health policy (Véron 2020).¹⁶ It could easily have turned out differently and might well do so down the road in a future nationalist U.S. administration. U.S. banking leaders seem to realize that their long-run business interest is best served if the United States respects its “soft law” international commitments in the financial sphere – thereby avoiding foreign government retaliation. That fear may not deter ideologically motivated politicians who might take power in the future.

It is hard to believe that the pre-crisis surge in gross cross-border financial activity shown in Figure 2 arose from a sudden rise in the inherent potential gains from international asset trade. A more likely reason is euphoria in financial markets and a reach for yield, supported by expectations of protection from the official sector and complemented by tax-related incentives for capital flow round tripping or detours through offshore havens.¹⁷ These transactions can cause gross capital flows to balloon, with much of the resulting activity being socially counter-productive. It is important to find the appropriate corrective policies for such cases. Reforms to date certainly have thrown some “sand in the wheels” of international finance, as shown by the breakdown of hallowed arbitrage relationships like covered interest rate parity, but we still do not have a full understanding of which policy-induced frictions are most helpful to limit distortive behavior, and which could also be harmful when markets become stressed.¹⁸ Further study can lead to refinements of the macroprudential toolkit, but we do need a

¹⁵ One emerging area of vulnerability relates to developments in fintech, including cryptocurrencies. Shiller (2019) gives a further example of the analogy between financial and pathogenic contagion, using epidemiological models (which economists embraced after the onset of COVID-19) to analyze the spread of economic narratives.

¹⁶ Facing the COVID-19 economic shock, the Federal Reserve on April 1, 2020 unilaterally suspended one aspect of Basel III, the Supplementary Leverage Ratio’s treatment of Treasury securities and central bank reserves. However, the Fed allowed suspension to expire (as initially planned) a year later.

¹⁷ On the important role of offshore financial centers in global capital flows, see Lane and Milesi-Ferretti (2018), Bertaut et al. (2019), and Coppola et al. (2020).

¹⁸ On the breakdown of covered interest parity, see Du and Schreger (2021).

robust toolkit, including the possibility of some differential treatment of international transactions.¹⁹ The adverse incentives that an expanding international safety net creates require a strong offset.

In sum, the threat of financial crises remains – not least, from origins in the less regulated nonbank sector – and potential gaps in international financial coordination persist. As Cecchetti and Tucker (2015, p. 106) summarize:

Cooperation means agreement, implementation, and enforcement of a common resilience standard. This, in turn, requires mutually agreed mechanisms for monitoring, combined with candid, honest, and regular communication. Should it be thought that those arrangements already exist, our experience suggests that it is, at best, a work in progress.

Turning to another weakness, we still do not know if international regulators would be able to pull off the orderly resolution of an insolvent globally systemically important bank. Such risks warrant further contingency planning by global regulators, but national fiscal authorities will also have to be on board.

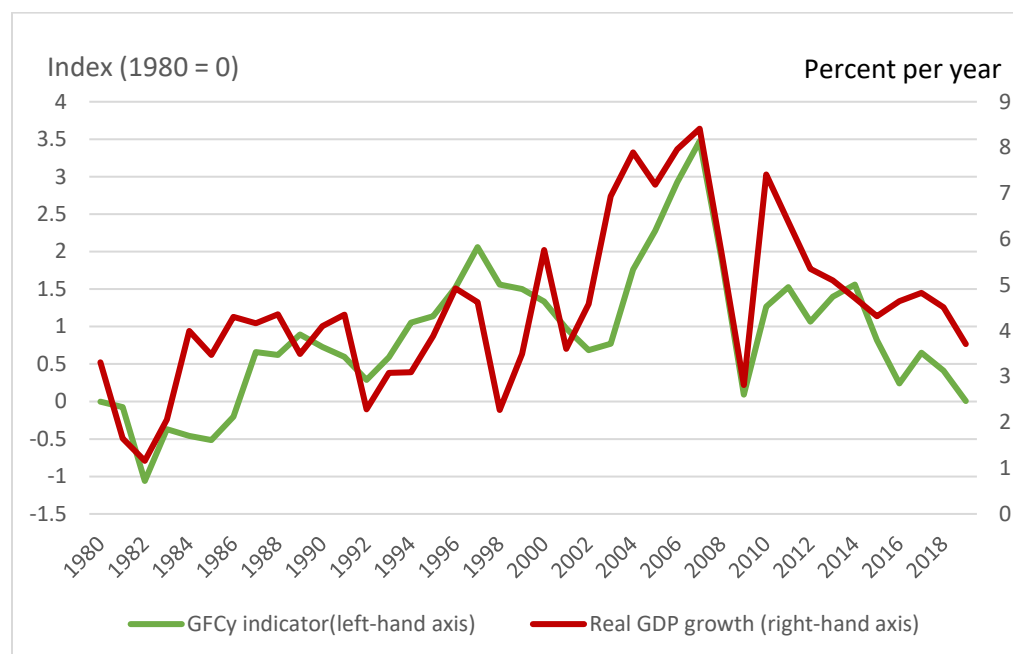
A specific potential coordination failure arises from possible asymmetry in macroprudential frameworks over the financial cycle. Financial history is replete with euphoric booms, during which vulnerabilities build up, followed by busts. Figure 2 gives striking testimony to the footprint of the 2000s boom in global financial markets. White (2020) makes the case that existing policy approaches focus excessively on ameliorating downturns and insufficiently on controlling the upswings that precede them and that sow the seeds of later problems. For example, Basel III allows a country to apply a countercyclical capital buffer to banks doing business within its borders, with foreign banks active in the country obliged to respect that buffer in calculating their capital charges on domestic loans. But the decision to invoke the buffer is at national discretion and likely to be asymmetric, with regulators biased against stifling domestic booms. White argues that one factor encouraging such asymmetry is regulators' unwillingness to disadvantage their own financial institutions relative to foreign competitors. Thus, an uncooperative equilibrium in policy rules – one without international agreement on macroprudential reaction functions – features excessive laxity in the cycle's boom phase.²⁰

Evidence has accumulated that the global financial cycle is worldwide in scope, with global movements in asset prices, commodity prices, leverage, and capital flows highly correlated internationally (for example, Miranda-Agrippino and Rey 2020). Due to America's weight in international finance and trade and the U.S. dollar's unique global role, U.S. monetary policy and financial conditions are the main drivers of the global cycle. Financial shocks originating in world markets pose special risks for LMICs, which generally have thinner foreign exchange markets and more fragile financial systems. Exchange-rate flexibility provides a partial buffer where practiced, but it cannot fully insulate LMICs from global financial forces. Figure 3 illustrates the high correlation between the global financial cycle indicator of Miranda-Agrippino and Rey (*GFCy*) and the growth rate of the aggregate real GDP of LMICs.

¹⁹ Macroprudential policies are policies that aim to enhance the stability of the aggregate financial system.

²⁰ Cecchetti and Tucker (2015) also stress the need for dynamic macroprudential policy coordination.

Figure 3 Growth in Emerging and Less Developed Economies is Highly Correlated with the Global Financial Cycle



Source: GFCy variable is from Miranda-Agrippino, Nenova, and Rey (2020), with data updated through 2019 available at <http://silviamirandaagrippino.com/code-data>. The raw monthly data are averaged to derive annual observations. Real GDP growth is from IMF, *World Economic Outlook* database, April 2020.

This vulnerability makes it understandable why so many less affluent economies, even emerging market economies, have stopped short of full financial opening (recall Figure 1). Indeed, in 2012 the IMF officially recognized this reality by developing an “institutional view” (IV) on capital controls that allows for their use in some circumstances, notably when financial flows threaten economic or financial stability and the capital flow measures (CFMs) do not substitute for necessary adjustments in macroprudential, monetary, or fiscal policies (International Monetary Fund 2012).²¹ The Fund’s acceptance of CFMs as a legitimate policy tool was a huge shift in approach: an aversion to exchange control resides deep within the institution’s DNA, and even an attempt to focus surgically on cross-border financial transactions could spill over to the current account.

Nonetheless, the IV is in several ways too restrictive. Research shows that CFMs are rarely imposed in the temporary manner the IV envisions, in response to cyclical tides in the global capital market. Instead, they are generally structural and thus long-lived in nature (Gupta and Masetti 2018). Notwithstanding the IV, many Fund members feel that global markets might stigmatize them if they vary CFMs reactively. Thus, the Article IV surveillance process has regularly featured disagreements between Fund staff and country authorities as to whether particular policy measures should be labeled as CFMs or MPMs (macroprudential measures), with the authorities often advocating for the latter designation (Everaert

²¹ Even before the IV, however, IMF staff accepted and even recommended capital controls in some individual country cases. For the case of Iceland in 2008, see Honohan (2020).

and Genberg 2020).²² A particular cause of disagreement has been policy in some countries (including some richer countries such as Canada) to limit foreign speculative purchases of property in soaring real estate markets. Finally, the IV is asymmetric with respect to inflow and outflow controls, restricting use of the latter to situations of imminent or ongoing crisis.²³ The Fund’s internal Independent Evaluation Office (2020) recognized these criticisms in a comprehensive review and recommended rethinking the IV.

Recently the Fund has proposed an Integrated Policy Framework that conceptualizes the use of CFMs, foreign exchange intervention, monetary policy, fiscal policy, and macroprudential policy as distinct instruments that may all be needed to reach multiple policy goals in a small open economy (International Monetary Fund 2020). Importantly, the approach has the potential to place capital control and foreign exchange intervention policies on an equivalent plane with monetary, fiscal, and macroprudential policies, and thereby remove some of the stigma that currently attaches to CFMs. In light of this work and the limitations of the IV, the Fund is currently reconsidering its advice on CFMs, and seems likely to go further in the direction of regularizing their use in a wider set of circumstances.²⁴ Following a 2016–2019 review, the revised OECD Code of Liberalisation of Capital Movements addresses some of the same criticisms IMF member countries have raised concerning the IV (Organisation for Economic Co-operation and Development 2020).

LMICs participate in the broader process of international financial cooperation, but that process frankly is skewed toward the interests of the big advanced economies, which dominate international financial activity. Unlike the advanced economies, most LMICs will continue for now to use modes of direct unilateral intervention to enhance their control over home financial markets, similar to what the original Bretton Woods blueprint foresaw. The distinctive problems LMICs face in coping with policy spillovers from the advanced economies would justify a more robust dialogue about those policies, and their impact on financial stability, in the councils of international financial institutions.

²² CFMs can play a macroprudential role—for example, when they limit foreign funding of imprudent domestic investments—but they can also play other policy roles that IMF rules proscribe—for example, preventing adjustment of an undervalued exchange rate. In contrast, a hypothetical “pure” MPM would not discriminate in its implementation between domestic and foreign residents. The overlap in the roles of MPMs and CFMs has sometimes blurred the distinction between them, as has the difficulty smaller countries face in counteracting the global financial cycle through MPMs without the support of measures that could be characterized (at least partially) as CFMs.

²³ Admittedly, it is usually harder to keep money in than to keep money out. But insisting that outflow controls not be deployed until it is (at best) almost too late can make a crisis more likely or harsher than necessary.

²⁴ As Honohan (2020, p. 25) puts it, the current IV approach “is quite different from seeing [capital flow] measures as a tool to be actively integrated with monetary, exchange rate, and macroprudential measures.”

The Future of the Global Capital Market

In a 1998 survey of the global capital market, I concluded:

Compared to the world of the late nineteenth century gold standard ... we increasingly reside in broadly democratic societies in which voters hold their governments accountable for providing economic stability and social safety nets. These imperatives sometimes seem to clash with the reality of openness. Despite periodic crises, global financial integration holds significant benefits and probably is, in any case, impossible to stop—short of a second great depression or third world war. The challenge for national and international policymakers is to maintain an economic and political milieu in which the trend of increasing economic integration can continue (Obstfeld 1998, p. 28).

More than two decades later, I have four reactions to that *fin-de-siècle* assessment:

- We came close to a new great depression in 2008-2009 and came close again in 2020 – the second time owing to a world war, not a war of country against country but one of all countries against a contagious pathogen.
- In addition, politicians and policymakers have not done a good job of maintaining “an economic and political milieu in which the trend of increasing integration can continue.” Among the consequences are trade and immigration backlash in the United States, political instability in Latin America, immigration backlash and growing nationalism in Europe, and Brexit. Related to these developments, my earlier optimism about expanding democracy now seems out of date.
- Global financial integration did continue after 1998 nonetheless, as measured by volume of transactions and interdependence of national financial systems, and has likely passed the point where further integration yields social benefits in excess of social costs.
- Despite all of this, there has been no significant rollback of the international capital market’s reach, and certainly no backlash against international finance comparable to the backlash against globalized production.

The seeming imperviousness of cross-border finance to broader political currents is a puzzle, especially after the Global Financial Crisis.²⁵

One factor relates to Mancur Olson’s (1965) account of the difficulty of enacting policy reforms with a concentrated set of losers, each losing a great deal, and a dispersed set of winners, each winning a small amount. International trade textbooks teach that the success of the multilateral trade rounds under the GATT, which opened world trade between the late 1940s and 1994, owed to their mobilization of a concentrated set of winners in each participant country – exporters – to act as a counterweight to import-competing sectors. Without such mobilization, trade opening is much more difficult because the dispersed winners each has little to gain by joining in to promote collective interests.

Political scientists such as Helleiner (1994) have suggested, however, that for international financial opening, the situation is the reverse: the winners are concentrated – the most influential are major exporters of financial services – while the losers, those harmed by financial instability – are dispersed.

²⁵ Adding to the puzzle, the lack of a broad public outcry coexists with cogent economic critiques of modern finance both from before the Global Financial Crisis and euro area crisis (for example, Rajan 2006) and after (for example, Wolf 2015).

Moreover, the losses from trade opening, as exemplified by abandoned factories in the U.S. Rust Belt, are much more salient to the general public than the losses from globalized finance, such as forgone tax revenues or a higher risk of crises that in most cases policymakers have ameliorated or contained. Most citizens find debates over financial regulation to be arcane and the likely consequences opaque. In sum, once the door cracks open, there is scant political resistance to the snowballing effect of financial-sector lobbying. These dynamics have led to financial regulatory cycles over centuries (Dagher 2018).

If this story helps explain why international financial liberalization has seemed to proceed so inexorably compared with trade liberalization, it may also explain the relative absence of a backlash against financial globalization. In the United States at least, backlash against trade has been strong enough to have captured both of the major political parties, whereas opposition to global financial activity is muted. But the losses from global finance have generally been more dispersed and less visible than those due to trade, while the financial community is well organized to resist restrictions on its cross-border activities.

The Global Financial Crisis stands out as an episode significant enough to have triggered a more durable backlash against finance in general. It did not. The crisis did lead to substantive financial reforms in the United States and, briefly, to popular protests in the form of the Occupy movement. But the policy approach of the Obama Administration was specifically intended to keep the financial sector in business, out of concern to avoid greater harm to the economy. There was no repeat of the Depression-era vilification of finance. The more enduring political legacy of the crisis, perhaps paradoxically, was a grassroots right-wing movement that *enabled* financial-sector political influence, as seen in the deregulatory bent and greater tolerance for global corruption of the Trump Administration. How this happened is still debated, but the political mobilization of cultural and racial resentments certainly played a role.

The Biden Administration is addressing some of the harms from international tax avoidance and corruption, and it will certainly adopt a stricter financial regulatory approach than its predecessor did. It will also retain a multilateral orientation in international financial policy that a generic future Republican administration could repudiate. The result of such repudiation could be greater financial instability, more public backlash against finance in general, and market segmentation along national or regional lines. Sentiment for limiting international financial flows has been expressed within both major U.S. parties, notably via proposed bipartisan legislation to tax U.S. foreign borrowing aggressively.²⁶

The current prospective policy mix of multilateral cooperation backed by internal guardrails will still concede much more to global financial capitalism than the original Bretton Woods settlement did. But it is more likely to produce a safer, more beneficial, and more sustainable version of financial globalization than an alternative path of beggar-thy-neighbor deregulation. In the end, the electoral appeal of President Biden's overall economic policy package may well be the major factor that determines the future of the global capital market.

²⁶ See Baldwin and Hawley (2019). The aim of the proposed legislation, however, is not to promote financial stability, but to limit trade deficits.

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