**Transnational Feedbacks, Soft Law, and Preferences in Global Financial Regulation**

**By**

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**Abstract**

Pre-crisis global governance of finance was marked by extensive cooperation supported by a preference alignment between the two regulatory great powers, the U.S. and the EU. The paper’s explanation of this surprising pattern in regulatory preferences takes the institutional context of global finance seriously. It highlights endogenous, temporal effects of the international institutions at the core of global economic governance and, in particular, *policy feedbacks* arising from the interaction of transnational soft law and domestic political contests. In this extension of historical institutionalist theory to the international political arena, soft law is more than a coordinating mechanism. It is an institution that, like its domestic analogues, structures politics over time, redistributing resources and altering contests between competing coalitions. In addition to improving our understanding of historical events and great power preference alignment, the argument develops claims about the temporal effects and domestic-international interaction of informal cooperation in global governance.

 In the sizable literature on the causes of the 2008 financial crisis (Lo 2012), one contributing factor has received relatively little attention: the pre-crisis cooperation between the two main regulatory powers, the US and the EU, and the preference alignment that sustained it. Had Europe in the early 2000s challenged US regulatory approaches in finance – as it had in other sectors such as chemicals and data privacy – one could imagine any number of different scenarios to the dismal one that unfolded: from fewer countries afflicted by banking and sovereign debt crises, to the absence of calamity and austerity policies within the eurozone.

Patterns of preference alignment (or diversity) among great regulatory powers are not just of real-world salience; they also pose a stubborn challenge to political economy theory. Power-based arguments do not anticipate the kind of preference harmonization observed in pre-crisis financial regulation. Because of differences in domestic (internal for the EU) regulatory structures, these accounts predict the rise of new economic centers to complicate collective action in the “clubs” that develop transnational regulatory standards. (Drezner, 2007). Nowhere should such complications have been more expected than in the case of pre-crisis finance, which witnessed the EU’s rise as a global rulemaker and the concomitant shift from US hegemony to transatlantic bipolarity. Finance is often depicted as the heart of national capitalist types (Zysman 1983; Hall and Soskice 2001; Deeg 2010; Hardie et al 2013). Change in domestic financial systems, while not purely path-dependent, had spawned complex cross-border diversity in Europe (Hardie and Howarth 2013; Hardie et al 2013) that should have diminished the possibility of finding common ground in the EU (Fioretes 2010; Zimmerman 2010; Howarth and Quaglia 2013) and increased the potential for preference heterogeneity under the new EU-US bipolarity. Power-based arguments would have expected rival standards – not great power preference alignment and cooperation (Drezner 2007; DeLong and Cohen 2010).

Neo-Marxist and other arguments stressing rising levels of capital mobility, among other factors, expect rules to reflect preferences of large internationally active companies (Baker 2010; Underhill and Zhang 2008; Tsingou 2008; Laurence 2001; Kurzer 1993) and would therefore better fit with the empirical record. Indeed, our evidence bears out a substantial role for such firms and their associations in forging similar approaches across the Atlantic. Yet this paper’s findings are consistent with recent scholarship (Young, 2012; McKeen-Edwards and Porter 2013) maintaining that these arguments are underspecified and cannot account for important variance in the influence of internationally active firms.

What accounts for the great power preference alignment over financial regulation and variance across time and subsectors in the pre-crisis years? Our argument, part of the latest wave of research on transnationalism,[[1]](#endnote-1) builds on historical institutionalist work by comparative politics scholars who take institutional context seriously.[[2]](#endnote-2) We highlight endogenous, temporal effects of the international institutions at the core of global economic governance – transnational regulatory networks[[3]](#endnote-3) – and, in particular, *policy feedbacks* arising from the interaction of soft law and the domestic politics of constituent members of the networks. The feedback processes under study entail “templates-as-disruptor” sequences in which the creation of transnational soft law by regulatory networks at t1 creates policy templates that disrupt pre-existing internal (e.g. domestic) political contests at t2. In this extension of historical institutionalist theory to global politics,[[4]](#endnote-4) regulatory networks and soft law are more than coordinating mechanisms or “rules of the game.” They are institutions that, like their domestic analogues, structure politics over time, redistributing resources, transforming the preferences of political actors and altering contests between competing political coalitions.[[5]](#endnote-5)

In the pre-crisis decades, the identified sequences are especially helpful for understanding the policy position of the main “second mover,” the EU, and why its preferences aligned with the regulatory “first mover,” the United States. In short, transnational soft law provided reform templates to opportunistic coalitions within the EU, which facilitated cooperation among the member governments and had the effect of bringing Brussel’s preferences closer to Washington’s. While our study focuses on the EU, corroborating research on China suggests a broader trend of soft law’s impact on domestic contests within second-mover regulatory powers.

Empirically, we test our argument through dynamic and static structured comparisons, including a six within-case study, to evaluate our claims against those offered by other accounts (Mahoney 2007; Bennett and George 2005). Our cases focus on policy reform in the EU during the late 1990s and early 2000s in sectors that have formed the basis of much previous research on global finance, while at the same time vary in outcomes (between preference alignment and divergence) over time and across subsectors, and our evidence includes new data, deriving from original interviews, primary documents, and historical analysis.

The paper makes several contributions. First, it responds to calls for better conceptual linkages between international and domestic financial arrangements (Helleiner and Pagliari 2011; Caparaso 1997). Specifically, it builds on an earlier body of research about the domestic effects of cross-border networks (Risse-Kappen 1995; Keck and Sikkink 1998; and Bob 2005) and suggests that soft law created in transnational bodies becomes a “domestic,” contextual factor that recasts national political bargains among coalitions hoping to alter the regulatory status quo. Second, the paper demonstrates how insights from historical institutionalism can be employed beyond comparative politics to better understand international dynamics (Fioretos 2011; Moschella and Tsingou 2013; Helleiner forthcoming; Farrell and Newman 2014). Transnational networks have become central elements of economic regulation. Scholars have paid insufficient attention to their temporal effects (Porter, 2011). Finally, it adds to our understanding of unanswered puzzles in the study of pre-crisis global finance – sustained cooperation in the face of structural change and financial crises (Drezner 2014; Helleiner 2014).

Explaining Regulatory Cooperation

 The puzzle of this study stems from the observation of preference alignment between the financial regulatory great powers in the pre-crisis period: the US and the EU. Before establishing that pattern and developing our argument, which highlights the interaction between transnational soft law and domestic politics, we review the two dominant analytic approaches used to understand the politics of global finance and highlight their empirical expectations.

One prominent approach employed to explain regulation of cross-border finance relies on state power, frequently operationalized by the relative size of national markets (James and Lake 1989; D. Vogel 1995). Scholars have enumerated a list of mechanisms by which market power may (or may not) produce regulatory harmonization. In a world characterized by a single, dominant regulator, the identified mechanisms include emulation, price signals, and coercion (Simmons 2001). Arguing that many sectors, including finance, had two regulatory powers (the EU and the US) in the pre-crisis years, Drezner (2007) theorizes that the extent and type of regulatory cooperation in a bipolar world depends on the preferences of the two powers. He anticipates that existing domestic regulatory structures will determine patterns of conflict and cooperation. In instances where regulatory structures are compatible, the two powers are said to have fairly similar preferences and cooperate to set club standards. Where existing regulatory structures significantly differ, cooperation would mean sizable switching costs. The result then would likely yield either sham or rival standards.

INSERT TABLE 1 HERE

There can be no doubt that the policy positions of jurisdictions with large markets play a crucial role in determining the global governance of finance (Helleiner 1994; Drezner 2014). Upon close inspection, however, state-power accounts fall short in explaining the conundrum that motivates this study: Why, with the rise of the European Union, did the increased number of great powers in finance not produce regulatory conflict as it did in other cases such as data privacy, chemicals and food safety (Table 1, EE1) (Pollack and Shaffer 2009; Vogel 1995; Newman 2008). Given the twentieth-century history of divergence in national financial models, the preference alignment between the EU and the US is a surprising outcome. Starting with Zysman’s (1983) pioneering work, scholars in comparative politics have highlighted persistent differences in national financial systems in Europe and across the Atlantic (Zysman 1983), including deeply embedded characteristics of countries’ political economies such as the nature of government oversight, sources and access to capital, and rules concerning market entry (Hall and Soskice 2001; Deeg 2010). Recent research, moreover, points to a new complexity of cross-jurisdictional similarities and differences in the years before and after the crisis (Hardie et al 2013; Hardie and Howarth 2013). Not only has finance varied considerably across capitalist jurisdictions but the differences also produced large adjustment costs for firms operating globally, an observation that has led scholars to predict preference divergence and regulatory confrontation within Europe and across the Atlantic (Kalinowski 2012; Fioretos 2010; Zimmerman 2009; Story and Walter 1997; Howarth and Quaglia 2013). Given the history of financial system diversity, internal EU agreement should have been more challenging and, by Drezner’s logic of bipolarity, EU and US preferences over regulation should have been farther apart. In short, there should not have been a marked shift from stalemate to cooperation in the 2000s, the pattern detailed below.

 A second account in the political economy literature on finance emphasizes the ability of transnational private market actors to pressure policymakers into adopting regulation with greater levels of firm discretion. Merging arguments about international class structure, technological change and relative asset mobility, these authors give pride of place to the role of transnational capital in systematically influencing rules (Baker 2010; Underhill and Zhang 2008; Tsingou 2008, Lall 2012; Perry and Nölke 2006; Nölke and Perry 2008; Gill and Law 1989). Multinational banks, asset managers and other financial services providers are said to have an interest in promoting neo-liberal policies that minimize oversight by public authorities. The central logic posits that financial firms possess a range of resource advantages relative to governments and other political actors – critical technical knowledge, close ties to political elites, organizational capacities, and the threat of exit, to name the most prevalent ones – all of which allow them to steer the policy agenda and outcomes, if not engage in straight out regulatory capture. Financial regulation is expected to mirror the interests of internationally active firms (Table 1, EE2).

 Large internationally active firms play an important role in regulatory processes, so we evaluate these arguments carefully. Yet a raft of research suggests that as explanations for the regulatory preferences of the leading regulatory jurisdictions, these arguments suffer from a number of deficiencies.[[6]](#endnote-6) Most relevant to our study, firm influence varies over time and issue area – even during periods when capital mobility levels are consistently high (Young 2012; Büthe and Mattli 2011; Lall 2012; McKeen-Edwards and Porter 2013, 8-9). This is what we find in our analysis of the EU’s financial regulatory overhaul of the 2000s, which is the key event in bringing about the great power preference alignment. In spite of a general neoliberal trend, there was considerable variation in adopted regulatory principles across financial subsectors – even during the same span of years and in the same polity, the EU. While scholars who prioritize the role of multinational firms by assumption have often nuanced their claims, the underlying explanatory logic – that firms get what they want – does not account for the widely observed variance in influence.

To help fill this gap and resolve the conundrum of EU-US preference alignment in the pre-crisis decades, we argue one needs to pay close attention to the institutional context that filters and shapes political contests, preferences, capacities and opportunities. By ignoring the institutional context of global governance, the leading accounts potentially suffer from omitted variable bias, over-emphasizing the effect of their variable of choice (Falleti and Lynch 2009).

Transnational Networks and Policy Feedbacks

 An important characteristic of the Bretton Woods system was that the IMF, the formal international organization charged with promoting international monetary cooperation (which included some authorities to regulate capital transfers), did not evolve into the central forum for financial regulatory cooperation.[[7]](#endnote-7) Instead, starting in the 1970s, financial regulators from major markets began to approach counterparts in other countries to manage the policy challenges of the nascent globalization of finance. Well-resourced agencies – e.g. the Federal Reserve, the Bank of England and the Securities and Exchange Commission – led the way in constructing the web of regulatory networks that would encompass dozens of forums including the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, the International Association of Insurance Supervisors and the International Accounting Standards Board (Porter 2005; Davies and Green 2008; Brummer 2012).

In some instances these networks comprised public sector regulators such as central bankers cooperating in the Basel Committee on Banking Supervision; in others, private sector “regulators” such as accounting experts meeting in the International Accounting Standards Board (until 2001, the International Accounting Standards Committee). Regardless of composition, the networks lacked formal treaty bases and rested primarily on non-binding international soft law. As the networks evolved they began to interact with one another and other international institutions in settings such as the Financial Stability Forum (now, Financial Stability Board) (Slaughter 2004).

 A large existing literature examines the role of these informal financial regulatory networks.[[8]](#endnote-8) This literature tends to emphasize the ways that the networks coordinate global standards (Slaughter 2004; Dehousse 1997; Raustiala 2002; Deeg and O’Sullivan 2009). This literature has been criticized, however, as overly functionalist, treating the networks as coordination mechanisms in largely depoliticized forums (Drezner 2007; Baker 2009; McKeen-Edwards and Porter 2013).

Building on recent work highlighting the political nature of transnational interactions (Cerny 2010; Djelic and Quack 2010), we argue such networks have additional, potentially extensive consequences beyond their coordination function. Similar to historical institutionalist explanations put forth by Comparativists, we focus on the ways that institutions structure politics (Steinmo and Thelen 1992; Mahoney and Rueschemeyer 2003). In particular, transnational regulatory networks generate policy feedbacks and thus serve as important sources of endogenous change.[[9]](#endnote-9)

 A workhorse concept in the field of comparative politics, policy feedbacks occur when governance decisions – that is, rule creation in the broadest sense – over time shape actor identities, interests and capabilities (Pierson 2006; Pierson 1993; Pierson and Hacker 2010). Such themes are well developed in cross-national research on the welfare state and on types of capitalism. Theda Skocpol, for example, identifies the role that the U.S. Civil War pension program played in forging a collective identity among veterans and organizing this new interest group to pursue the expansion of social programs (Skocpol 1992). Similarly, Peter Evans examines how differences in civil service personnel rules in Brazil and South Korea altered the ability of the state to promote business innovation (Evans, 1995). This literature stresses that in addition to the formal ‘rules of the game,’ public “policies frame the choices of political actors both by creating resources and incentives and by influencing the efforts of individuals to interpret the social world” (Pierson, 1993: 628).

We extend the approach to the transnational setting, drawing especially from domestic policy feedbacks resulting from the administrative capacities of states. Here, the configuration of the bureaucracy and regulatory apparatus structures opportunities and constraints that encourage some reforms over others. Jonah Levy, for example, demonstrates how statist policies in post-war France undermined coalitions attempting to decentralize in later periods (Levy 1999).[[10]](#endnote-10)

In our adaptation of the concept, policy templates developed by transnational soft law have similar endogenous effects. Such transnational templates should not be conceived as separate from the longstanding and well-documented national contests between conflicting coalitions over financial regulation, but rather as among the key domestic political factors that actors can use to bolster the position of their coalition over another.

Recent research shows such soft law “template-as-disruptor” sequences occur even within the U.S., in contrast to previous scholarship that treated the country as a unitary actor, more or less uploading its preferred rules to the transnational level (Lavelle 2013, 232-240; Foot and Walter 2010). For example, the June 2004 passage of Basel II, a BCBS accord on capital reserve requirements for banks, illustrates how new transnational agreements can reflect the agenda of one domestic U.S. coalition (comprised of the Federal Reserve, the Treasury, the SEC and international banks) over another (led by the Federal Deposit Insurance Corporation) and then ricochet back into existing domestic conflicts. Indeed, the Basel II agreement altered the U.S. regulatory reversion point by helping the pro-Basel faction legitimize the rules they favored[[11]](#endnote-11) and diminishing the bargaining power of the FDIC in its efforts to resist the adoption of more flexible capital reserve requirements for the largest banks (Lavelle 2013; Foot and Walter 2010; Bair 2012).

We expect sequences similar to this U.S. one to occur in rising economic powers (i.e. second movers), where typically there exists consensus over the need to catch up with the leading power but conflict over how to do so. The key issues regarding great power preference alignment turn on second-movers and why they might adopt transnational rules that bring them into line with the leading country as opposed to adopting homegrown standards that might spawn rival global rules. Whereas reformist coalitions are unlikely to overcome opposition to their preferences for copying the first movers’ rules (because copying can be easily criticized as ceding regulatory sovereignty to the leading jurisdiction); status quo advocates typically lack sufficient capacities and political agreement to forge homegrown solutions that would lessen the adjustment costs of catching up. In this context the presence (or absence) of transnational soft law is likely to play a salient role in bringing about (or not bringing about) alignment.

Pro-reform factions in second-mover polities will see in transnational soft law a mechanism for advancing their agenda. In contrast to the alternative courses of action, the adoption of transnational soft law needs little local know-how or experience, and enables pro-reformers to legitimize their preferred rules by framing the adoption as a politically neutral, ready-made solution (Risse-Kappen 1995). While the details will vary across cases, the core idea is that the creation of transnational templates is likely to set off a sequence of events that improves the position of reformist coalitions in rising economic powers and contributes substantially to the convergence of great power preferences.

This discussion yields the following relevant empirical expectations that we evaluate, below, against the historical narrative and other arguments:

*E1: Given proximity of transnational standards to first-mover regulatory approaches, the creation of standards at t1 is likely to bring about great power preference alignment at t2.*

*E2: Transnational soft law alters domestic political debates in second-mover jurisdictions, increasing the probability that reformist factions can break through political impasses.*

 We evaluate these empirical expectations for the primary example of a rising financial power in the pre-crisis decades (i.e., the EU) and in the context of securities oversight, corporate governance and banking rules. Cases within these regulatory areas have received extensive attention in the scholarly literature. They are critical, in the sense that valid arguments must be able to account for them. We use structured comparisons and process-tracing exercises to tease out the causal mechanisms at play and contrast them to alternative expectations derived from state and firm power arguments.

**The alignment of preferences: Feedbacks through the template-as-disruptor effect**

The evidence of this section reveals the importance of feedbacks in bringing about the US-EU financial regulatory preference alignment: Reformist coalitions in Europe used newly available soft law templates to win domestic political contests over internal regulatory modernization and thereby brought about the alignment. These findings and our critique of other explanations are based on a within-case comparison across six issues that were highly contested. We start by providing background on the regulatory agencies (mostly US and British) that shaped initial transnational standards and then show how in future periods these standards influenced the preferences of rising economic powers.

*Setting Early Standards for Cross-Border Exchange*

Early regulatory cooperation in banking is perhaps the best known and also one of the clearest cases of regulators forging the terms of transnational cooperation. Research from Kapstein (1994) to Singer (2007) demonstrates the critical role that US and British regulators played in shaping the content of capital adequacy rules codified in the Basel I accord. Responding to the entry of Japanese banks into global finance, the Federal Reserve and the US Treasury worked with their British counterparts to construct a set of international standards that could externalize their regulatory goals.

 In the case of securities, early IOSCO standards similarly reflected the relative regulatory capacity of US representatives (Singer, 2007). While standards on regulatory oversight or insider trading mirrored US regulatory experience, the micro or macro economic benefits to such a regulatory system were highly disputed (Kerner and Kucik 2010). During many of the IOSCO discussions, the SEC enjoyed a privileged position vis-à-vis other representatives. Several large countries including Germany and the United Kingdom had a long tradition of self-regulation for the financial services sector and sent representatives from self-regulatory bodies to IOSCO meetings. Even after independent domestic agencies were established in these countries, they lacked the technical expertise and staff enjoyed by the SEC (Lutz 1998; Deeg and Luetz 2000). Long before the networks actually contributed to policy coordination, US regulators had left a significant imprint on their animating ideas and norms.

 The IASC/IASB process offers an important additional example of how even in the case of private actor governance, regulatory authorities, played a critical role. In the 1980s, the SEC became increasingly interested in international market regulation in general and the work of the IASC in particular. The SEC used the newly-created IOSCO to engage with the IASC. Working through the Compatibility Project, members of the IASC and IOSCO attempted to revise IASC core standards so as to eliminate variation and develop a functioning set of international standards (Camfferman and Zeff 2007). By the end of the IOSCO-IASC interaction in the late 1990s, the core standards had been significantly narrowed and strengthened (Ibid.). IASC could credibly argue that their standards formed the basis for a global convergence project. The SEC succeeded in steering this process, so as to shape the content of IASC standards to converge along principles largely compatible with U.S. ones.

Despite considerable influence, it is important to underscore the fragmented interests of US regulators during this time period. For example, the Fed was unable to convince the SEC to promote global capital adequacy rules and as a result there were no comparable rules for investment banks with the release of Basel I (Singer, 2007). Similarly, the FDIC, as noted, vehemently resisted Basel II but ultimately lost the battle to other interest constellations (Lavelle 2013; Foot and Walter 2010; Bair 2012). Finally, within the SEC there was considerable disagreement between the international office and the more traditional departments over participation in IASB development (Camfferman and Zeff 2007). In short, many of the templates created in initial periods represent less a unified “US” position than the position of an influential regulatory actor that was able to steer the transnational rule setting process – at a particular time and in a particular forum – despite the sometimes unsettled nature of the issues at home. Moreover, the below analysis of specific regulatory areas illustrates that domestic regulatory battles do not end with the introduction of transnational soft law.

*EU Modernization through Templates*

This section establishes the role played by transnational standards in restructuring internal political contests facing the rising financial power, the European Union. In instances where templates were available, EU member countries were more likely to overcome internal political stalemates and adopt a regulatory approach fairly close to that of US regulators. This template-as-disruptor effect (E1) helps to explain why realist expectations of diverging great power preferences were rarely realized (Table 1, EE1) and why industry lobby arguments are insufficient (Table 1, EE2). After documenting congruence between the presence of transnational standards and Transatlantic alignment, we show, through process tracing, how the two are causally linked.

In the mid-1990s, EU policymakers faced a dual challenge of constructing a modern financial regulatory framework that could underpin the single currency while also responding to competitiveness challenges posed by US and Asian markets. The Financial Services Action Plan or FSAP (the legislative agenda) and the Lamfalussy process (the adopted rulemaking procedures) transformed financial regulatory rulemaking into a Brussels-based governance system (Mügge 2010; Quaglia 2008b and 2010). One US Treasury official deeply involved in Transatlantic economic cooperation describes the scope of reform: “Imagine in the United States, Graham-Leech-Bliley, US General Accepted Accounting Practices, the Securities Act of 1934, and Sarbanes-Oxley legislation being adopted within five years.”[[12]](#endnote-12)

Many of these reforms took on a neoliberal character, which shared considerable affinity with US approaches (Mügge 2011a, 186; Posner and Veron 2010). The result of these reforms was Transatlantic normative alignment in many critical issue areas. Commenting in 2006, the same US Treasury official wrote:

EU and US financial market rules are firmly anchored in the international system... The US, EU member states and the EC participate in the same international organizations that provide frameworks for financial market regulation. These common frameworks provide the basis for convergence of US and EU regulations.[[13]](#endnote-13)

It is hard to exaggerate the subsequent impact of the great power convergence: 1) the management of conflicts in the 2000s (generally preempting the development of rival standards); 2) the continuity and deepening of the neoliberal financial regulatory rules that set the stage for crisis; and 3) coordinated regulatory reforms in the immediate aftermath of the great financial crisis (Lannoo, 2011). What makes this alignment striking is the prior decades of policy stalemate rooted in alternative national models of finance within the EU (Story and Walter 1997; Zysman 1983). Transatlantic alignment and cooperation only became a possibility when EU decision-makers were able to move beyond many of these longstanding political conflicts.

*Soft Law as Disruptor and Alignment Mechanism*

The availability of transnational templates was a key variable in the causal sequences behind the EU-US preference alignment. To substantiate our argument that templates served as disruptors and harmonizers, we take advantage of variance within the regional modernization effort. Not all areas of EU financial regulatory reform produced transatlantic alignment. We examine six core financial regulatory issues (accounting standards, capital reserves, financial conglomerates, insurance, company law and financial instruments) that feature prominently in previous studies of financial reform within the EU (Quaglia 2010; 2014; Mügge 2010).

INSERT TABLE 2 HERE

We find alignment with US approaches in the three areas where transnational soft law existed prior to EU regulatory modernization (accounting standards, capital reserves and conglomerates) and alignment in only one (financial instruments) of the three where it did not (insurance, company law and financial instruments). In 2002, the EU adopted legislation[[14]](#endnote-14) requiring that companies listed on EU stock exchanges employ IAS/IFRS developed by the IASB by 2005. Like the US GAAP, the IAS/IFRS (despite considerable differences) were designed to cater to the informational needs of investors (Perry and Nolke 2006b; Nölke and Perry 2008; Büthe and Mattli 2011). Similarly, the EU transposed and implemented the 2004 Basel II agreement giving banks greater discretion over minimal capital requirements.[[15]](#endnote-15) Finally, the 2002 Financial Conglomerates Directive[[16]](#endnote-16) mandates that a single regulator must oversee all components of large financial conglomerates with the goal of reducing regulatory arbitrage.[[17]](#endnote-17) The blueprint for the directive, like the two previous examples, was transnational standards (the 1999 Joint Forum on Financial Conglomerates, in this instance).[[18]](#endnote-18)

By contrast, we find considerably less Transatlantic alignment in company law and the regulation of the insurance sector, both domains where little and weak prior transnational soft law existed. While there is a transnational network of insurance regulators known as the International Association of Insurance Supervisors (IAIS), it was founded first in 1995 and had no consensus standards concerning solvency rules when the EU underwent its modernization. In the absence of transnational guidance on insurance regulation, EU’s Solvency II directive[[19]](#endnote-19) follows a homegrown approach and is at odds with US practices. Insurance has been a critical area of prolonged and intractable global financial regulatory conflict. In company law, an area devoid of transnational regulatory cooperation, deeper integration failed as EU governments, each with their own traditional model, could not agree on a joint template (Callaghan and Höpner 2005; Fioretos 2009). Transatlantic authorities have had to make exceptions where necessary to overcome incompatibilities between American and European national company law.[[20]](#endnote-20)

The one anomaly to the pattern is the EU’s 2004 Market in Financial Instruments Directive (a revision of a 1993 directive, the Investment Services Directive or ISD, aimed to liberalize cross-border trading of financial instruments and investment services provision). While not contradicting the templates-as-disruptors proposition, this case indicates equifinality (i.e. more than one causal path to the same outcome). Despite the absence of transnational soft law concerning the core issue (i.e. how to structure cross-border competition of securities trading and investment services),[[21]](#endnote-21) the EU eventually adopted more liberalized rules largely mirroring the direction of U.S. reforms (Quaglia 2010, 83-90; Mügge 2010, 125-142).

Observing congruence between transnational soft law and great power preference alignment is one thing. Establishing a causal link is quite another. Does the evidence support our proposition that the existence of transnational templates increases the probability that reformers will adopt convergent policies? Our process-tracing exercise suggests the answer is yes.

By the late 1990s, a core group of reform minded European policy elite, spearheaded by the European Commission and supported by reformist factions in the U.K., emerged in favor of rapid financial regulatory integration. This reformist coalition faced persistent obstacles stemming from core differences in the political economy of finance across Europe that had vexed previous harmonization efforts. Key to the political bargain that emerged was that EU financial integration, unlike monetary union, would encompass all member states, including the U.K. with its leading international financial center. Even without Britain’s inclusion, there were numerous other sticking points among Continental members (for example, resistance to the creation of supranational financial authorities), not to mention among EU political institutions (Pollack, 2002; Buerkle 2002). Because of the UK’s inclusion, however, the challenges to reform were all the more considerable, as the governments had to find common ground between the continental countries, especially the relatively heavily banked and embedded German and French financial systems, and the U.K. with some of the world’s largest capital markets and a fairly unembedded light-touch regulatory regime (Mügge 2010, 31-50).

The FSAP legislative package represented ongoing and unsettled political battles over the rules of finance: Many proposals were revisions of previous legislation from the 1980s (European Commission, 1983 and 1985; Posner 2009). Neatly captured by Story and Walter’s phrase “battle of the systems,” this earlier project was fraught with incompatible national preferences and, by consequence, yielded weak legislation that had little bearing on financial regulation on the ground (Story and Walter 1997; Underhill 1997). Even after agreement on many elements of the FSAP, scholars continue to find deep-seated differences in preferences and beliefs among the major economic players within the EU (Quaglia 2010; Fioretos 2010).

Why were Europeans able to overcome abiding differences in several core issue areas at the turn-of-the-millennium that seemed intractable in the 1980s and early 1990s? Clearly, this process is neither monocausal nor deterministic as each piece of legislation has an idiosyncratic political story. In some areas, there had been significant regulatory reforms inside member states since the mid-1980s. In others, the shift in policy preferences of the largest financial firms had brought German and French governments closer to long-standing British (and neoliberal) positions (Mügge 2010, 31-49).

A theme across cases is that the presence of transnational soft law increased the probability that battling negotiators would find agreement and tilted outcomes in favor of reformist coalitions. In accounting standards, for example, core differences between national models – such as principle versus rule-based standards or fair value versus historic value – had long stymied meaningful reform (European Commission, 1995). The European Commission, in a document anticipating the completion of improved international reporting standards, made explicit how IFRS could be used to outflank internal resistance and political impasse:

No further progress has been made at EU level in harmonising the basic rules on accounting and financial reporting. There is disagreement between Member States about the usefulness of the Directive [referencing existing accounting rules] as an instrument for accounting harmonization…It would however be difficult to agree on the issues which should be covered in such a revision. Some Member States might seek to renegotiate parts of the Directives they do not like. The preparation and negotiation of such an important revision of the Directives would take a long time (Ibid: 3-5.).

While IFRS and USGAAP are not perfectly convergent, they are increasingly compatible, as demonstrated by the US SEC’s decision to allow IFRS for reconciliation by foreign issuers.

The role of transnational soft law in banking, while equally important for transatlantic alignment, was subtler as it occurred incrementally over a fifteen-year period. The gradual transformation in Europe is quite remarkable, given the initially stark contrast in regulatory practice across the member states as well as the ineffective preexisting rules (e.g. 1977 First Banking Directive). Two issues fragmented European preferences. Capital adequacy levels across the member states varied considerably, with French banks among those with the fewest reserves and British banks among those with the most; and differences in banking structure between more universal banking models and segmented banking models. The direction of reforms could thus have important externalities (Oatley and Nabors 1998).

Even in early Basel I discussions, European reformists saw potential tools for advancing their agenda to coordinate national banking regulation inside the region and internationally (European Commission, 1983:17; Story and Walter, 1997: 281-283). Commitment to a single European passport for banks under the principle of mutual recognition, codified in the 1988 Second Banking Coordinating Directive, necessitated harmonization of capital reserve requirements (to ensure a level playing field) and made the newly agreed Basel I rules so appealing to European reformists (European Commission, 1985).[[22]](#endnote-22) The incorporation of Basel I was an attractive alternative to the daunting challenge of devising a European template at a time of vast differences in national capital requirement approaches. The Basel guidelines were not only international “best practice” but also provided significant flexibility (notably by not giving a common definition of capital and thereby accommodating the poorly capitalized French banks) (Story and Walter 1997, 283) and appealed to the British government, which had long advocated the creation of a European financial area (Ibid., 276-281) and supported the US bid to create international requirements because of competitiveness concerns vis-à-vis Japanese banks.

The 1989 precedent of using Basel rules in EU legislation was repeated in subsequent legislation[[23]](#endnote-23) when the European Commission listed revision of EU capital adequacy legislation as among the goals of the FSAP’s financial regulatory overhaul (European Commission, 1998 [18-20] & 1999 [29]). Thus, as Basel rules became more neoliberal (see below), so too did Europe’s. Transnational templates did not complete the global harmonization process, as domestic pushback against US Basel II compliance and continued disagreements over Basel III within the EU demonstrate. Yet they brought Europe and the US closer on the ground rules for capital adequacy standards.

Financial conglomerates is similar in that the preexistence of a transnational template helped to restructure internal bargains and brought the EU into closer alignment with the U.S. Previous efforts to establish consolidated supervision in Europe failed to overcome core sectoral differences. Each sector ended up with its own directive (Coates 2001; Gruson 2004, 363-364). The adoption of a single national regulator for all financial services sectors in the UK (1997) and Germany (in 2002) prompted their governments to take the lead in the new legislative effort.

The availability of the 1999 Joint Forum’s principles for supervision of financial conglomerates facilitated Europe-wide agreement.[[24]](#endnote-24) Like a new technology, the Joint Forum’s principles concerning coordination of authorities and supplementary supervision (atop of existing “silos”) offered Europeans a way around the political impasse concerning sectoral differences (Gruson 2004). The new approach won over the resistance of Mediterranean countries and some of the new member states, which had not adopted the single regulatory model at the national level and were reluctant to alter existing domestic arrangements (Quaglia 2010, 63). Moreover, by writing legislation based on international best practice and including provisions that required foreign firms – especially U.S. ones – operating in London (and elsewhere in Europe) to have equivalent supervision or be subject to the EU’s regime, the Brussels accord was able to satisfy British concerns (Ibid. 64).[[25]](#endnote-25)

The adoption of the Joint Forum template was not politically neutral. It eased agreement in the narrow area of consolidated supervision but sparked new conflicts, one of which prompted Transatlantic alignment. Internally, by borrowing the Joint Forum’s emphasis on coordinating mechanisms, the directive aggravated a simmering battle over oversight and led to the extension of the Lamfalussy architecture to banking, insurance and conglomerates (and to the ECB’s continued relegation to the sidelines of banking supervision).[[26]](#endnote-26) Externally, by requiring equivalent supervision for U.S. and other foreign firms operating in the EU, after an initial Transatlantic spat, the SEC introduced a new holding company rule also designed to meet international best practice (Posner 2009; Dür 2011).

*Alternative Arguments*

Do the counter arguments better explain great power alignment? The power-based account (Table 1, EE1) faces a number of challenges. First, it has little purchase on the overarching pattern of preference alignment or the variation across subsectors. The power-based model assumes that existing internal regulatory structures prior to global cooperation determine great power preferences. Yet assuming fixed and largely domestically derived preferences generates an expectation of preference divergence across the Atlantic. Our six-subsector study finds internal policy paralysis within Europe that then gives way to internal reform and transatlantic policy alignment - in the majority but not all instances (i.e., insurance and company law). Thus, the power-based approach not only incorrectly predicts the probability of transatlantic alignment but also offers no mechanism to explain subsector variance.

Is the great power preference alignment better conceived as a function of organized international firms (Table 1, EE2)? Several types of evidence run counter to such arguments. First, the regulatory capture account faces similar difficulties in explaining variance in transatlantic cooperation across subsectors as organized international firms have fairly constant incentives, well established in the literature, to promote regulation that expands firm discretion. Second, leading political actors in Europe were not captured by industry. Even Daniel Mügge’s careful study, which emphasizes the importance of the largest international banks in Europe’s financial regulatory overhaul, supports our claim. With its attention to transnational public-private alliances, Mügge’s argument maintains that the policy entrepreneur behind the FSAP, the European Commission, “had already reached its position in favour of further integration...”(Mügge 2010, 93-94). Third, contrary to expectations by the mobility argument, at the time of the EU reforms cross-Atlantic private sector coordination hardly existed. Once EU policymakers had decided to move ahead with the legislative agenda, US banks were first to lobby – a fact that triggered angry reactions from their relatively poorly organized European counterparts (Wicks, 2004).[[27]](#endnote-27) Unable to sway EU policymakers to their satisfaction, US banks turned to the US Congress, Treasury and the SEC for help.[[28]](#endnote-28) When the extraterritorial effects of EU and US legislation sparked regulatory conflicts, US and EU firms were sometimes on opposing sides.

Finally, the public-private alliance between the biggest banks, the European Commission and “Northern” governments comprised the anchor of the broad European coalition of reformers in long-standing political battles over financial regulation. There is no doubt this coalition did better than the competing one. [[29]](#endnote-29) The evidence from our study, however, shows that the reformists did not win every battle; and that transnational templates played a significant role across cases in bolstering their relative bargaining power. In the absence of transnational templates, it is hard to imagine that the EU would have gone nearly as far in this direction as it did.

At the end of the millennium, the EU faced a number of pressures to modernize its financial architecture including spillovers from its internal decision to construct a single currency and growing competitiveness challenges from abroad. Nevertheless, reformist policy-makers faced entrenched institutional and sectoral differences (e.g. universal versus fragmented banking, fair value versus historical value accounting, anti-trust versus competition policy, and interlocking directorates versus independent boards to name a few), which generated preference heterogeneity across the member states and frequently sham standards or policy failure internally. How this reform program was resolved and on what terms, played a critical role not only for Europe but for cooperation globally. While not the result of a monocausal pathway, as demonstrated by the case of financial instruments, our evidence strongly supports that the existence of transnational templates produced policy feedbacks that increased the probability of reform. Standards created in earlier periods with significant input from US regulatory actors, provided reformist coalitions in later periods with important leverage in domestic debates. In adopting these templates, reformists could navigate the delicate political divide between member state divisions while at the same time (often unintentionally) promote preference alignment globally.

*Transnational Soft Law as a Mechanism of US Regulation?*

One lingering question, rooted in a variant of Realist skepticism (Tablel 1, EE1), is whether US regulators had intentionally used transnational soft law to bring about EU convergence to US approaches. If this were the case, our assumption of pre-crisis EU-US financial regulatory bipolarity (borrowed from Drezner and others) would be misguided, as US hegemony would never have ended.

Such a logic, which sees transnational soft law as a US tool for transforming European financial arrangements rather than a source of independent, temporal effects, engages in ex post analysis and makes incredulous assumptions about the ability of actors to strategize into the future. In 1998, when the European Commission first proposed the FSAP, no one in Europe, let alone across the Atlantic, anticipated the concatenated factors that produced financial regulatory harmonization in the region – and therefore that European policy entrepreneurs would find transnational templates so useful.

Indeed, the EU project occurred when US financial regulatory strategy vis-à-vis transnational bodies was not focused on Europe. US authorities during this period supported the enhancement of transnational standards and bodies primarily as tools for reforming “crony” financial systems of Asian and other “emerging” markets in the wake of the Asian Financial Crisis (Blustein 2003). Even in the prior case of Basel I, U.S. authorities were motivated primarily by the threat of Japanese banks and not the potential payoff of the agreement to transform Europe (Kapstein 1994; Singer 2007; Oatley and Nabors 1998). The lack of US attention to EU matters is understandable, given the record of regional integration failures. European policymakers had launched a previous regulatory project in 1985, which fell woefully short of the “single financial market” goal (Story and Walter 1997). In 1995, when the European Commission proposed EU adoption of international accounting standards, for example, US officials had good reason to think the plan would never come to fruition. Two earlier pieces of EU accounting standards legislation (The Fourth [1978] and Seventh [1983] Company Law Directives) had accomplished little. For much of the 1990s, pressure from the New York Stock Exchange to maintain US market competitiveness, not the prospect of EU emulation, drove intermittent SEC’s interest in IOSCO and IASC.[[30]](#endnote-30) Moreover, that most countries have adopted IFRS must have come as a surprise to SEC officials who assumed that it was a matter of time before US GAAP would become the global standard (Levitt 2001).

U.S. officials misjudged and misperceived EU reforms in other ways. The EU’s Financial Conglomerates Directive is a case in point. With reference to the Transatlantic conflict over the FCD, a U.S. Treasury official wrote:

The atmosphere surrounding the initial meeting was charged with suspicions by some market participants that EC officials wanted to “push back”… The initial meeting between the US and EU experts did not confirm these concerns, but dispelled them.[[31]](#endnote-31)

The strategic action of US authorities notwithstanding, it is still possible that soft law functions as a subtle diffusion mechanism of US structural power. Here, again, the evidence from careful process tracing suggests a more complex picture. The US does not operate as a unitary state in transnational regulatory bodies, and “American” positions often reflect one side in unsettled domestic political battles. In the case of Basel II, as noted, there emerged a wide distance between commitments made by US representatives and an opposing coalition of the FDIC and small and medium-sized banks. A similar divergence occurred in the conglomerates case, where U.S. Treasury representatives did not even recognize that the EU’s adopted regulation reflected previously agreed Joint Forum principles. A second reason is that political battles over regulation are ongoing both inside the US and in transnational bodies. For example, the SEC won a major fight over the IASB’s governance structure in 1999 (Martinez-Diaz 2005), yet FASB and IASB are different standard-setting organizations, have different degrees of autonomy from political influences and, indeed, reacted differently at times to crisis-induced pressures. There is no guarantee that IFRS will reflect the SEC’s preferences in the future; and transnational standards do not change in lock step with US reforms.

**Conclusion**

Our paper addresses a core question in political economy: How to explain regulatory preference alignment in a world of rising economic powers? Given the differences in models of capitalism across the advanced economies, such alignment should be particularly difficult and indeed has proven so across many, if not most, domains – yet not in finance. Our paper draws attention to the international institutional context and in particular processes endogenous to transnational regulatory networks to explain the similarity of great power preferences. The creation of transnational templates that largely reflected US regulatory approaches gave rise to an important feedback, which structured internal European Union distributional contests and thereby reduced preference heterogeneity between the US and the potential challenger. When the EU sought to reform internal governance, its leaders borrowed extensively from the existing palette of templates. The resulting harmonization supported Transatlantic alignment.

A study of this kind naturally has limitations. Our transnational feedback claim does not attempt to provide a universal and subsuming theory but rather to draw attention to a causal mechanism with explanatory power that sometimes complements but often offers more satisfying accounts than existing arguments. By focusing on the twenty years before the financial crisis, moreover, this study is empirically restricted to the EU as a rising power, a case that suggests the importance of domestic preference heterogeneity or policy stalemate and internal demand for regulatory solutions as preconditions for template adoption. Future work will be necessary to develop these boundary conditions further and evaluate the argument in the context of newly rising financial powers, such as China, as well as historical cases, such as Japan in the 1980s. Our preliminary assessment of existing research suggests encouraging support for our arguments as well as limitations. Some Chinese authorities promoted transnational financial regulatory templates in order to resolve internal political dilemmas (Walter 2010; Shih 2007). For example, the passage of the Basel II agreement fed back into an existing domestic struggle between technocratic-reformists and old-style pro-growth factions. By arguing the Basel rules were international best practice, the reformists improved their hand and ultimately were able to adopt Basel II rules (Walter 2010, 162-163; Foot and Walter 2010; Shih 2007).

Drawing attention to institutional feedbacks in global financial regulation points to several avenues for future research. First, it responds to calls for better conceptualizations of domestic-international linkages in the area of financial regulation (Helleiner and Pagliari 2011). Here, rather than accept the relatively narrow set of intended and functional effects of transnational networks (Slaughter 2004), the paper builds on an earlier generation of research about transnationalism (Risse-Kappen 1995; Keck and Sikkink 1998; Djelic and Quack 2010). In the pre-crisis decades, transnational financial regulatory bodies did not take on a role comparable to transnational advocates of human rights or other norms (Keck and Sikkink 1998). Like some of the previous literature, however, our approach stresses how transnational rules become politically relevant facts on the ground in domestic political contests.[[32]](#endnote-32) The main insight is that transnational standards are likely to be attractive for some domestic political actors who see them as potentially beneficial to their campaigns in ongoing political battles. While this study focused on the two international rule makers in the area of financial regulation during the pre-crisis era, the framework is potentially more general. Because of the distributive nature of most financial regulatory arrangements, the rules governing the sector tend to be highly contested. Regardless of the particular content of soft law, some participants in these contests are likely to perceive soft law as potential resource.

Second, the paper takes time and temporality seriously in international politics (Buthe 2002; Fioretos 2011; Moschelle and Tsingou 2013). It demonstrates not only the relevance of tools developed in comparative politics such as policy feedbacks but adapts them to the international and transnational setting. This exercise produces analytically novel expectations about context that can be tested in other empirical settings. Additional work could translate other concepts common in comparative politics such as institutional layering or drift to global phenomenon (Thelen 2004).

Finally, by improving our understanding of the pre-crisis Transatlantic preference alignment, this paper also helps to clarify some of its normative implications. Harmonized regulatory approaches facilitate cooperation and smooth the bumps in globalization processes. They may also contribute to intellectual and governance monocultures (McNamara 2009) that may seem quite vibrant in periods of stability but may also predispose economies to quick and rapid collapse.

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**Notes**

1. For a general review of the research on transnationalism, see Djelic and Quack 2010. Cerny 2010 is an example of the latest generation of research. For specific applications to finance, see McKeen-Edwards and Porter 2013; Botsem 2012; Hussain and Ventresca 2010; Nölke and Perry 2008; Perry and Nölke 2006. On the second generation, see Risse-Kappen 1995; Keck and Sikkink 1998 and Slaughter 2004. On the first generation, see Nye and Keohane 1971. [↑](#endnote-ref-1)
2. For parallel arguments prioritizing the institutional context see (Berger 1981; Woll 2008; Falleti and Lynch 2009. [↑](#endnote-ref-2)
3. The term network is used empirically to describe informal soft law coordination (Zaring 1998; Raustiala 2002). The literature generally does not use the term to invoke analytic concepts of social network analysis. We follow the literature. [↑](#endnote-ref-3)
4. On IR’s historical institutionalist turn, see Fioretes 2011; For its application to global finance see Moschella and Tsingou 2013; Lall 2012; Helleiner forthcoming. [↑](#endnote-ref-4)
5. In the domestic setting see (Campbell 2003; Paul Pierson and Hacker 2010; and Thelen 2004, Steinmo and Thelen 1992). [↑](#endnote-ref-5)
6. McKeen-Edwards and Porter (2013) offer a comprehensive critique of what they call “unified dominance models” (p. 6). [↑](#endnote-ref-6)
7. See Article VI of the Articles of Agreement of the International Monetary Fund (www.imf.org/External/Pubs/FT/AA/index.htm#art4). [↑](#endnote-ref-7)
8. For basic overviews of the field, see (Brummer 2012; Porter 2005; Davies and Green 2008; McKeen-Edwards and Porter 2013). [↑](#endnote-ref-8)
9. For other research attentive to temporal effects in the area of financial regulation see contributors to Moschella and Tsingou 2013. [↑](#endnote-ref-9)
10. See also Skocpol 1992: 58. [↑](#endnote-ref-10)
11. On the legitimizing effects of transnational norms, see Risse-Kappen (1995). [↑](#endnote-ref-11)
12. Former U.S. Treasury official’s correspondence with author, 31 May, 2006. [↑](#endnote-ref-12)
13. Former U.S. Treasury official’s correspondence with author, 31 May, 2006. [↑](#endnote-ref-13)
14. Regulation (EC) no. 1606/2002 of the European Council and Parliament, 19 July 2002. [↑](#endnote-ref-14)
15. The Capital Requirements Directive includes both the Directive 2006/48/EC and Directive 2006/49/EC. [↑](#endnote-ref-15)
16. Directive on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate 2002/87/EC of the EP and the Council of the EU. [↑](#endnote-ref-16)
17. The extent to which the FCD can be classified as neoliberal remains an open question depending on one’s interpretation of the fact that non-EU firms choose the national competent authority who determine whether the foreign jurisdiction had equivalent regulation. [↑](#endnote-ref-17)
18. Joint Forum of Financial Conglomerates, “Supervision of Financial Conglomerates,” BCBS/IOSCO/IAIS, February 1999. [↑](#endnote-ref-18)
19. **Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009.** [↑](#endnote-ref-19)
20. For example, on exceptions made to accommodate Germany’s dual board system, see Tafara (2004, 8). [↑](#endnote-ref-20)
21. IOSCO’s 1998 “Objectives and Principles of Securities Regulation” lacks guidance on the issue. See Mügge 2010, p. 66. [↑](#endnote-ref-21)
22. European policymakers implemented Basel I rules in the Own Funds Directive [Council Directive 89/299/EEC] and the Solvency Ratio Directive [Council Directive 89/647/EEC]. [↑](#endnote-ref-22)
23. This was the case in the 1993 Capital Adequacy Directive (93/6/EEC) that accompanied the Investment Services Directive. [↑](#endnote-ref-23)
24. For an example of how EU policymakers framed the directive in terms of international best practice, see Rapporteur Alain Lipietz’s comments in (COM(2001) 213. C5-0159/2001. 2001/0095(COD), A5-0060/2002 Final, 27 February 2002, 32-33. [↑](#endnote-ref-24)
25. David Green, “A European Regulatory Perspective,” FSA Speech, Annual Washington Conference of the Institute of International Banking, March 4, 2002. http://www.fsa.gov.uk/library/communication/speeches/2002/sp92.shtm. [↑](#endnote-ref-25)
26. Tom Buerkle, “European Disunion,” *Institutional Investor*, July 1, 2002. [↑](#endnote-ref-26)
27. Author’s interview with Nigel Wicks, a member of the Committee of Wise Men on the Regulation of European Securities Markets (2000-2001), Florence, June 18, 2004.). [↑](#endnote-ref-27)
28. Author’s interview with senior staff official, US House of Representatives, 6 May 2004, Washington, DC. [↑](#endnote-ref-28)
29. Quaglia identifies two main coalitions: a market-making coalition that more or less corresponds to Mügge’s and a market-shaping coalition (2010). [↑](#endnote-ref-29)
30. Written correspondence with former SEC Chairman, April 13, 2007. [↑](#endnote-ref-30)
31. Former U.S. Treasury official’s correspondence with author, 31 May 2006. [↑](#endnote-ref-31)
32. In contrast to Ikenberry (2001), who emphasizes the role of formal institutions as lock-in mechanisms, we demonstrate how informal institutions can recast the internal political debate within rising powers. [↑](#endnote-ref-32)