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# Domestic Ideas and Interests in Global Governance: Comparing German and U.S. Preference Formation

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# **Domestic Ideas and Interests in Global Governance: Comparing German and U.S. Preference Formation**

By

**Stefan A. Schirm**

## **Abstract**

Financial crises underline the necessity for more effective governance of global markets. While the New Basel II Accord showed the possibility of multilaterally creating better governance, no agreement has been reached on the reform of the International Monetary Fund (IMF). Why do governments agree on a reform of global financial governance in some cases, but not in others? I argue that convergence and divergence of governmental positions towards new governance cannot be explained solely by the logic of the international system nor by globalization, but instead strongly reflect domestic ideas and interests. In addition, I argue that variation in success in achieving new governance is shaped by the different impact of ideas versus interests on the ability of governments to compromise internationally. But when do ideas prevail over interests and vice versa? In this regard, I argue that ideas prevail when new governance initiatives affect lobby groups only diffusely and concern fundamental questions on the role of politics in governing the economy. Interests prevail when specific lobby groups are affected directly and when new governance initiatives try to administer the distribution of costs and gains sectorally. The arguments are tested in case studies on the preference formation of the U.S. and German governments on the reform of the IMF and on Basel II in 2001-2007.

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## Preface

This paper was presented during a conference on 'Germany in Global Economic Governance', which took place at Cornell University on Feb. 22/23, 2008. It was organized by Stefan Schirm (Ruhr University of Bochum) and Hubert Zimmermann (Cornell). We would like to thank our sponsors, the DAAD (German Academic Exchange Service), the Department of Government, the University of Bochum, the Mario Einaudi Center for International Studies, the Institute for European Studies as well as Peter Katzenstein (Cornell), who served as commentator.

Germany, still the third or fourth largest global economy, has been particularly active in proposing a tighter regulation of international financial markets. We use Germany as an exemplary case of how medium-sized countries can shape global governance and how the political economy of countries with coordinated market economies conditions their global governance strategies as compared to so-called liberal market economies, such as the United States and the United Kingdom. With this focus, the project permits and initiates an overdue dialogue between the literatures on varieties of capitalism and on global governance, using global governance as the dependent variable. Another objective of the workshop was to address the dearth of country-specific case studies in research on global governance which often treats all states as essentially similar in their reaction to economic globalization.

Contributors were asked to look at various areas of global governance (such as hedge fund regulation, IMF reform, Basel II, pharmaceutical regulation, corporate governance, transgovernmental standard-setting, etc). All papers identified several levels shaping the German position: the subnational, the European and the global level. The German government, with varying success, engaged in strategic forum-shopping among these levels. A further characteristic was close cooperation between state and non-state actors. Overall, the extent of Germany's capacity to shape global governance is surprisingly large.

## **Domestic Ideas and Interests in Global Governance: Comparing German and U.S. Preference Formation**

### **Introduction<sup>1</sup>**

Economic globalization through cross-border financial flows is only partially matched by political globalization in the form of multilateral rules for global markets. Some instances witnessed the creation of new political initiatives such as the Basel II Accord and the Financial Stability Forum. At the same time, the political management of financial crises through a reform of the International Monetary Fund (IMF) was not improved substantially. The only partial globalization of politics can be considered a drawback, since globalization - defined as the growing share of cross-border economic activity in total economic output – has increased instability in the world economy. This became evident with the number and severity of financial crises, such as those in Latin America and Asia, in the 1990s as well as in the financial market turbulence in the industrialized world in 2007-08.

These crises and conflicts are not restricted to individual countries, but increasingly affect all countries integrated into the world economy. Financial crises, for example, did not only damage directly involved emerging markets such as Thailand, Indonesia, Argentina, and Russia, but also industrialized countries in Europe and North America through a selective breakdown of trade, losses for creditor banks and stock exchange turmoils. Thus, not only are developing countries and emerging markets subject to crises induced by globalization, but the industrialized world is as well. Although globalization is not necessarily a homogenous force, the governments of those countries which are heavily integrated in the world economy share a common perception of the need for a better governance of globalization via more efficient multilateral rules for the prevention and management of financial crises. This common perception is acknowledged by the

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governments of the most important actors in today's international political economy. Even before the current financial market turbulence, key decision makers from the industrialized countries, including Germany and the U.S., stressed the need for better global economic governance, for example:

- U.S. Secretary of State Colin Powell (2001) declared that: “(...) in our increasingly globalized world, America's prosperity and well-being are linked ever more closely to expanding growth and stability worldwide. That is why strong United States leadership in the IMF, the World Bank and the WTO is so crucial to America's future and the world's future.”
- The White House (2006) under President George W. Bush stressed in its National Security Strategy: “In our interconnected world, stable and open financial markets are an essential feature of a prosperous global economy. We will work to improve the stability and openness of markets by (...) strengthening international financial institutions”.
- Germany's Chancellor Gerhard Schröder (2002) emphasized the necessity for a new political architecture of the world economy: “After all, we need a truly democratic trade and financial regime in the world.”
- Germany's Chancellor Angela Merkel (2007) declared at the World Economic Forum in Davos: “We politicians know these fears [of globalization] well and therefore have to do everything to shape globalization politically. (...) We want to minimize the systemic risks of international capital markets (...). We need a coherent, joint action in many international bodies.”

This shared perception of the need for better global economic governance often does not translate into compatible positions on the form of desired new governance. Differing strategies for the design of new rules can be found even between industrialized countries of the G7. On the governance of financial markets, for example, one can observe diverging preferences between the American and German governments with regard to the reform of the IMF: while the United States prefers a restriction of IMF activities to emergencies, the German government wants to expand the Funds programs as well as its

governmental funding (Gamble 2004; Helleiner/Momani 2007; Schirm 2004). Thus, the core questions are: Why do governmental preferences on new rules for global markets diverge? Why do governments agree on a reform of global economic governance in some cases, but not in others?

The paper is structured as follows. Section two discusses core elements of research on global economic governance and delineates where the explanatory gap lies. In order to close this gap, I propose an analytical approach, which argues that national preferences on global economic governance strongly reflect domestic ideas and interests. In addition, I argue that variation in success in achieving new governance is shaped by the different impact of ideas versus interests on the ability of governments to compromise internationally. But when do ideas prevail over interests and vice versa? In this regard, I argue that ideas prevail when new governance initiatives affect lobby groups only diffusely and concern fundamental questions on the role of politics in governing the economy. Interests prevail when specific lobby groups are affected directly and when new governance initiatives try to administer the distribution of costs and gains sectorally. These arguments are then briefly tested in sections three and four through case studies on the formation of the preferences of the governments of the United States and Germany on the reform of the IMF and on the Basel II Accord in 2001-2007.

### **Analytical Framework**

Research on global economic governance has focused on the international system as the level of analysis and has investigated predominantly questions on the performance of international organizations, on intergovernmental negotiations, and on the legitimacy of actors (see e.g. Barnett/Duvall 2005; Bird 2003; Bradford/Linn 2007; Diehl 2005; Hall/Bierstecker 2002; Kahler/Lake 2003; O'Brian et.al 2000; Nunnenkamp 2003; Nye/Donahue 2000; Shaffer 2005; Scholte 2003). Most studies do not open the black box of the state by asking for endogenous, societal reasons for governmental positions. Instead, states are often taken as unitary actors (such as “the U.S.A.”, Higgott 2004: 11), without considering the heterogeneity of domestic politics in pluralistic democracies. National preferences are often derived from the international system, that is, from a

neorealist perspective on the international distribution of power or from an institutionalist perspective on the configuration of international rules and expectations. Regarding the methodology and the theoretical approach, many studies focus on institutionalism and regime theory (see e.g. Adler and Bernstein 2005; Onuf 2002).

I argue that in order to understand the problems in achieving better global economic governance, more research has to be focused on the domestic sources of the sometimes converging and sometimes diverging preferences of national governments. Despite the growing importance of private actors in shaping global governance, national governments remain core actors in this process. Drezner (2003: 36) confirms the gap in research by stressing “the need to focus more clearly on the origins of great power preferences in the global economy. (...) what drives the preferences of relevant actors? How can we divine what governments want?” More research on the domestic sources of governmental preferences seems to be especially important because differences in governmental positions towards global governance are often an obstacle for improving the management of globalization.

This paper intends to answer the questions outlined above with a societal approach to governmental preference formation, thus complementing the dominant focus in research on regime theory and institutionalism. Following the liberal theory of international relations, I will focus on the influence of domestic politics on governmental preferences on foreign (economic) policy and on the interaction between globalization and domestic politics (Frieden/Rogowski 1996; Moravcsik 1997; Putnam 1988; Schirm 2002a: 33-56, Weiss 2003). My core argument is that the diverging positions of governments towards global economic governance and the variation in their ability to compromise on multilateral economic agreements is strongly shaped by domestic ideas and interests. The argument is based on the assumption that governments in democratic political systems represent dominant societal influences which can range from specific lobby groups to the attitudes of voters. Thus, governmental positions express preferences originating from societal influences prior to international strategies and interstate negotiations. This implies, “that states do not automatically maximize fixed, homogeneous conceptions of



security, sovereignty, or wealth per se, as realists and institutionalists tend to assume. Instead (...) they pursue particular interpretations and combinations of security, welfare, and sovereignty preferred by powerful domestic groups” (Moravcsik 1997: 519).

In order to understand international behavior of states it is thus necessary to first analyse the domestic sources of governmental preferences. For this purpose, I suggest two explanatory variables: because governments want to be re-elected, they are responsive in democracies to the way in which both domestic material *interests* and value-based *ideas* relate to globalization and global governance. With these variables the paper addresses both the more recent material changes brought about by globalization as well as the longer term values of the societies affected by globalization. It differs from most other approaches by including two driving forces in the analysis which are usually employed exclusively. The inclusion of both variables is based on the assumption that individual as well as governmental preferences and actions can be influenced either by short-term material considerations or long-term ideas individually, or by a combination of both. Obviously, not only ideas and interests compete with each other in influencing preferences, but in pluralistic societies different interests and different ideas also compete amongst themselves. In addition, both can interact with each other in a non-competitive way. For example, dominant ideas can reinforce or weaken specific interests and changing interests can trigger a socialization process which can change ideas (on the interaction between ideas and interests see Goldstein/Keohane 1993; March/Olsen 1998; Thelen 1999: 379-381). The two variables shall be defined as follows:

*Interests* are defined here as material economic considerations of domestic groups which can change rapidly according to changing circumstances, that is, according to new incentives and costs induced by globalization and (new) global governance. This definition is based on analyses concerning the interaction of economic internationalization with domestic sectors and politics, for example, by Jeffry Frieden and Ronald Rogowski (1996) and Andrew Moravcsik (“commercial liberalism”, 1997). Frieden and Rogowski (1996: 35) argue that globalization, as “the exogenous easing of international exchange”, leads interest groups to pressure the government into

establishing competitive conditions. Moravcsik (1997: 528) emphasizes that changes in the structure of the domestic and global economy alter the costs and benefits of transnational exchange, creating pressure on governments to facilitate or block such exchanges. My own previous research (Schirm 2002a) confirmed this point in comparative country studies, revealing that, because of globalization private interests have increasingly positioned themselves along transnational economic considerations in influencing governmental preferences. Therefore, in this paper the suspected causal connection between interests and governmental preferences focuses on the material impact of globalization and/or (new) global economic governance in form of (expected) changes in (domestic) economic conditions. This focus seems plausible, because private interests are increasingly tied to the world market through the growing share of the transnational economy in a country's national product. This connection can occur, for example, in the form of a company's or a sector's more positive attitude towards further globalization due to a successful competitive position on the world market. Likewise, increasing integration of national economies can trigger opposition towards further integration if jobs and profits are threatened by global competition or (new) global governance. In each case, lobbying groups such as employer associations and trade unions would articulate their interests vis-à-vis the government. Methodologically, it has to be empirically shown if and how the material interests of dominant actors towards globalization and global financial governance (liberalization, protectionism, standards etc.) are reflected in governmental positions and their ability to compromise.

*Ideas* relevant for global economic governance preferences are defined here as path-dependent and value-based collective expectations in a given society on how politics should govern the market. Ideas can express themselves in societal attitudes and, in an institutionalized form in the political culture and system of a country. Like interests, ideas can change, but changes take longer than changes in material interests due to the path-dependent character of ideas. A value-based idea is relevant for the re-election of a government if it possesses high commonality (is it shared by a large number of citizens?) and specificity (is its meaning precise?) (Boeckle and Rittberger and Wagner, 2001: 109-110). This conception of the variable "ideas" is based on my own previous research on

societal norms (Schirm 2002b, 2004, 2005) as well as on Moravcsiks “Ideational Liberalism” (1997). In further developing Moravcsik’s approach, I differentiate between *process ideas* and *content ideas* (Schirm 2004: 12). Ideas relating to political *process* are defined as dominant expectations about the way political decision making should be conducted and can favor, for example, the inclusion of all relevant societal groups in the form of the idea of “consensual decision making,” as is found in Germany, or stress “majoritarian and competitive decision making,” as found in the U.S. Ideas relating to the *content* of politics express what a society sees as a core task of the state in a given policy area. In the economic realm, competing content ideas can be, for example, “individual responsibility” and “trust in market forces” versus “public solidarity” and “regulating market forces.” As stated earlier, ideas and interests may interact by re-enforcing or weakening each other. For example, the intensity with which interests influence governmental positions may depend on the set of ideas on the related issue such as the idea of “individual responsibility” supporting the material interest in “liberalization.” Methodologically, it has to be empirically shown if and how endogenously dominant ideas are reflected in the preferences of the governments towards global financial governance and can thus explain the divergence or convergence in these preferences, as well as the varying ability of the governments to compromise.

Summing up, the following three questions and hypotheses form the analytical framework and will guide the empirical research in the case studies:

**1.** Why do governmental preferences agree on the necessity of global governance, but often disagree on its form? *If endogenous ideas and/or interests differ between states, then diverging governmental preferences on global governance are to be expected despite a similar perception of the need for a better management of the world economy.* Preferences towards global governance are the dependent variable, while endogenous ideas and interests constitute the independent variables. It has to be analyzed empirically how far the preferences correspond to endogenously dominant, and in cross-country comparison possibly diverging ideas and/or interests. With “interests” I refer to the costs

and incentives felt by a sector or company as a result of its competitive situation in world markets and/or within the scope of potential new governance rules. With “ideas” I refer to fundamental attitudes towards the role of politics in governing the economy.

**2.** Why do governments agree on a reform of global financial governance in some cases, but not in others? *If differences in material interests between countries dominate governmental preferences, then an agreement on new governance through compromise is more likely than in situations where differences in ideas dominate.* The dependent variable is the agreement on new governance, while the dominance of interests over ideas in governmental preferences constitutes the independent variable. It has to be analyzed empirically, first, whether divergent material interests shaped the positions of governments in instances of successful negotiations on new governance and, second, if divergent ideas were dominant in instances of unsuccessful negotiations. Hypothesis II is more complex than Hypothesis I and seems plausible because different material interests can be settled in an international negotiation process more easily through calculating a mutually acceptable distribution of costs and benefits than can differences in value-based ideas. As the settlement of the latter requires consensus among the differing parties, it seems to be more difficult to achieve on the international stage than domestically because there is no international society which can come to a new consensus on ideas the way national societies can. Societies may be increasingly influenced transnationally, but they are still predominantly constituted nationally. Thus, ideational divergence can also be part of an international negotiation process but is *less likely be settled by compromise* than diverging interests due to the roots of divergence in path-dependent values of national societies.

**3.** Under which conditions do ideas prevail over interests and under which conditions do interests prevail over ideas? *When special interests are affected directly and distributive questions dominate, then interests will prevail over ideas in shaping governmental preferences. When interests are affected in a diffuse way and fundamental questions about the role of politics in governing the economy dominate the governance debate, then ideas will prevail over interests.* The dependent variable here is the prevalence of either

ideas or interests and the independent variable is either “interests affected diffusely and fundamental governance questions dominate” or “special interests affected directly and distribution of costs dominate”. The hypothesis seems plausible because if special interests are directly affected with regard to costs, then the respective actors and their lobby groups have a strong incentive to influence the government. On the other hand, if interest groups are only affected in a diffuse way and fundamental questions on the political governance of markets dominate the governance debate, then basic societal attitudes will be more relevant while interest groups do not have the motivation for intense lobbying (Schirm 2007b: 314-316). Moravcsik (1997: 529) illustrates this point with regard to trade policy: “Recent research supports the view that protectionist pressure from rent-seeking groups is most intense precisely where distributional concerns of concentrated groups are strongest.” Thus, I argue that interests will prevail over ideas when (new) global governance initiatives directly affect organized interests with adjustment costs. If not, ideas will prevail over interests in shaping governmental preferences.

The analytical framework developed here intends to complement other approaches and the explanatory variables *ideas* and *interests* should neither be seen as deterministic, nor as exclusive. Other factors than endogenous interests and ideas might, of course, also influence governmental preferences and their ability to compromise multilaterally. The argument here is that the focus on international institutions and regimes, on power, on the legitimacy of non-governmental actors and on globalization has to be analytically complemented by examining ideas and interests within national societies as foundations for governmental preferences and thus as a possible explanation for success and failure in achieving new forms of global economic governance.

### **Operationalization of case studies**

In sections 3 and 4, I will briefly give evidence for the explanatory power of the hypotheses in case studies on the preferences of the German and the US governments on a reform of the IMF and on the Basel II Accord in the period 2001 to 2007. This period encompasses the debate and the negotiations for a reform of both governance institutions

starting in the aftermath of the Asian Crisis for the IMF and with the first proposals to substitute Basel I in the end of the 1990s. The two empirical cases IMF and Basel II were chosen in order to present a variation from successful (Basel II) to non-successful (IMF) cooperative situations. Keohane (2002: 252) underlines the relevancy of studying this variation: “[W]e can not understand why institutions vary so much in their degree of effectiveness simply by studying institutions. To focus only on existing institutions is to select on the dependent variable, giving us no variance and no leverage on our problem. On the contrary, we need to explore situations in which institutions have not been created, despite a widespread belief that if such institutions were created, they would be beneficial”. The countries analyzed in both cases are key players: the US and Germany figure among those states with the largest voting quotas (within the IMF) and influence (Basel Committee) as well as open ambitions to reform both institutions. In analyzing the possible relevance of ideas for governmental positions, I will use speeches by heads of governments and top representatives of the responsible ministries (finance, economy, foreign affairs). In these speeches, I will search for evidence that shows whether or not the preferences differ along the fundamental ideas on policy contents and on political process relevant in the respective society. In examining the possible influence of *interests*, I will use speeches and press releases of (potentially) affected business associations as well as documents and speeches of the politicians and ministries in charge and analyze whether or not their positions correspond to the material interests of business groups.

Exemplifying hypotheses via the statements of politicians can provide only plausibility, not proof. A public statement by the government underlining its positions with material interests or ideas does not necessarily provide the “real” reasoning behind the government’s preference. When governments underline their preferences with ideas, then they can, for example, also draw a rhetorical picture to promote hidden material agendas such as protectionism or market access. However, public statements give evidence for what the government considers acceptable to the voters and therefore legitimate. Thus, I assume that governmental preferences will in principle reflect attitudes grounded on “real” endogenous patterns of legitimate ideas and interests. In order to secure this link

between governmental preferences and societal ideas and interests, the empirical evidence on the dependent variable – governmental preferences - focuses on quotes of decision makers of the politically responsible ministries and of heads of government who, based on the standard assumption of self-interest to remain in office, will base their positions on patterns acceptable and thus legitimate in the eye of voters. Positions of experts are not considered because they do not ultimately decide and because they are not accountable to voters. The following quotes serve as an exemplary illustration of governmental positions.

### **Domestic Ideas and Governmental Preferences: The Reform of the IMF**

The International Monetary Fund (IMF) was created as part of the Bretton Woods system and aims at securing the stability of exchange rates and the international balance of payments. If a member country has problems with its balance of payments, it can ask the IMF for financial assistance, which the latter then provides under the condition that the borrower adjusts its economic policy in order to improve its balance of payments. After the breakdown of the Bretton Woods exchange rate regime in the 1970s, the IMF played a crucial role in managing the debt crisis in Latin America in the 1980s, the financial crises in Asia in 1997/98, and in other emerging markets such as in Russia and Argentina in the last ten years. The IMF has been criticized for not preventing these crises and for mishandling their management for example in South Korea and in Argentina (Bird 2003; Blustein 2003; Meltzer Commission 2000). In addition, recently the IMF is facing a declining demand for its loans because newly industrializing countries such as China, Brazil and Argentina built up huge currency reserves in order to protect themselves against financial market turmoils independently of the IMF. Also, since the end of the 1990s the United States government has been advocating a reduction of the IMF's programs and funds as a measure to focus the Fund on its core duty (surveillance of exchange rate) and to prevent it from providing a safety net ("moral hazard") for financial market actors through huge lending in crises situations, thereby leading it to follow a more market-based approach (Helleiner/Momani 2007: 2-10; Kenen 2007; Schirm 2004).

The IMF has also been criticized for being an instrument of the foreign policy of its most influential member state, the U.S.A.. Indeed, studies confirm that the IMF over time did act in favor of the policy goals of the United States and its banks (Broz/Hawes 2006). Thus, it is puzzling that the U.S. government has been demanding a downsizing of the IMF's activities and budget in the last decade because this might counteract the strategic interests of the U.S. as well as the material interests of its banking community. According to Broz and Hawes (2006: 374-376) major American international banks heavily lobbied Congress in the 1990s to increase the Fund's spending ability in order to secure IMF bail-outs as an insurance for their loans to developing and newly industrializing countries. Thus, a specific puzzle arises with regard to the U.S.: Why does the U.S. government favor a restriction of the Fund's activities (contrary to Germany), given the fact that the IMF fulfills U.S. strategic as well as economic goals? In order to answer this question it is promising to go beyond the examination of "interests" as an explanatory variable as Broz and Hawes do, and analyze "ideas" as a formative influence on governmental positions towards global governance.

In addition to this specific puzzle for the U.S., the general puzzle of the paper is also accentuated with regard to the IMF: Why do governments diverge on strategy, when they agree on necessity? Since the 1990s several financial crises increased the necessity for a more efficient management of global financial markets by the IMF. This need is acknowledged by governments, but no substantial reform of the IMF has been achieved due to diverging positions among key players, even among G7 countries, such as Germany and the U.S. The following examination will show that - regardless of the potential economic benefits of more efficient governance and material considerations - the positions diverge because they are shaped by diverging *ideas* on how to steer the economy prevailing in the two countries. Special *interests* and distributive questions were only affected in a diffuse way and material interests of domestic groups could not be detected in governmental positions. The dominance of ideas can be evidenced in the most important issue areas of IMF reform with regard to both the *decision-making process* of



the Fund and the Fund's strategic *policy contents*. First, the independent variable "ideas" introduced in the previous section shall be specified with some empirical examples for the two countries under scrutiny here as follows:<sup>2</sup>

With regard to ideas on the contents of *policy*, the tendency is that Americans emphasize the role of the market and of individual responsibility, while Germans tend to emphasize the role of the state and public solidarity. Also, in the U.S. "solidarity" is seen less as a governmental stronghold (as it is seen in Germany), and more as the realm of private charity. On the role of the state, figures from Heien (2002: 113-114) show that the state is held responsible for the provision of healthcare by 67.8% and for the living standard of the elderly by 73.6% of Americans, but by 92% of Germans in both fields. Also, more Germans agree than disagree with the statement that the state is responsible for the reduction of income inequalities (net figure: +22.5%) while more Americans *disagree* than agree with that as a state responsibility (net figure: -6.6%). Data from WVS (2004: V 142) on the role of private responsibility for the economy show that 26% of Americans favor more private ownership of business as compared to only 14% of Germans. The gradual and not fundamental differences expressed in these figures are reflected in the economic systems of the two countries. Both are market economies, but while the U.S. is seen as a liberal economy, Germany is considered as a social market economy (see next paragraph).

With regard to ideas on the political *process*, the basic tendency is that Americans accept majoritarian decisions and the-winner-takes-it-all situations more than Germans, who emphasize consensual decision making and the inclusion of all relevant actors. This difference is also gradual and not fundamental in nature, as both countries are pluralistic democracies and share both ideas – however, not to the same degree. Empirical evidence on diverging *process ideas* with regard to the market as a process driven predominantly by either private actors or the government can also be found in figures from the WVS (2004: V144, V 157): While 30% of Americans support the statement that competition is

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<sup>2</sup> In order to give evidence for path-dependent "ideas", public opinion polls will only be used if they refer to fundamental value-based expectations on the role of the government, individuals, and the market and not if they refer to situative opinions on specific present-day policy questions.

a force for good, only 16% of Germans agree to that statement. Diverging confidence in market forces is also expressed when 54% of Americans, but 36% of Germans show “confidence in major companies” (“a great deal/ quite a lot”). These different process ideas are expressed institutionally in form of the “coordinated” versus “liberal” character of the two economic systems according to Hall and Soskice (2001). The “coordinated” patterns in Germany and the “liberal” ones in the U.S. can be taken as evidence for the institutional anchoring of the ideas of “solidarity/ consensual decision making” in Germany and “individual responsibility/ competitive decision making” in the U.S. (also see Ganßmann 2003; Pauly/Reich 1997; Scharpf/Schmidt 2000; Schirm 2002b: 222-224; Seeleib-Kaiser 2001). In the following I will show that these gradual differences in the independent variable “ideas” are reflected in the dependent variable “preferences of governments” with regard to the ideas of “public solidarity/ individual responsibility”, “regulation of market/ trust in market”, and “inclusive decision-making/ leadership according to contributions”. The quotes were taken from the leading politicians from the national ministries responsible for dealing with the IMF, that is, the U.S. Department of the Treasury and the German Ministry of Finance.

### *Decision-making*

The IMF is governed by its members, whose power rests on their respective voting quotas. With 17% of the votes, the United States has the largest quota and a veto power because fundamental decisions have to be approved by 85 % of all votes. Japan and Germany possess the second largest voting quotas and the OECD countries together own more than 50% of the votes. The distribution of voting quotas today does not reflect the rise of emerging markets in the last 20 years and is therefore often criticized because it endangers the acceptability and therefore the legitimacy and efficiency of the Fund. Many developing and newly industrializing countries and also some industrialized countries - such as Germany and the U.S. - are underrepresented when comparing their voting quotas in the IMF and their share in world-GNP. A very modest increase of the quotas of four emerging markets (Turkey, South Korea, Mexico, China) was agreed upon in 2006. No substantial reform was achieved because of divergent preferences of key players.

Germany and the United States differed fundamentally with regard to quota reform. Germany advocated an increase in voting shares of developing and newly industrializing countries (NICs) and was willing to give up a share of the voting power of industrialized countries - including its own - in order to change the distribution of power within the decision-making process of the IMF. In contrast, the United States wanted to increase the voting shares of some NICs and developing countries without reducing its own voting share and thus endangering its veto power. The U.S.'s only concession was that it was willing to forgo an *increase* of its quota. The reasons for these diverging positions given by the responsible policy makers clearly reflect the different ideas prevailing in the two societies on how to organize policy processes: While the U.S. stressed leadership, the shareholder character of the IMF and the link between contributions to the fund and voting shares, German policy makers emphasized consensual decision making by underlining the "equality" of all participating countries regardless of financial contributions:

- U.S.: Secretary of State Colin Powell (2001) stressed the necessity of a "strong United States leadership in the IMF."
- U.S.: "The IMF is a shareholder institution" (John W. Snow, Statement by the US Treasury Secretary 2005).
- U.S.: "The United States is not seeking to increase its own quota share and will not accept any decline" (Timothy D. Adams, Undersecretary for International Affairs, US Department of the Treasury, 2005).
- U.S.: "We repeat our commitment to forgo the additional quota we would receive in the second stage increase beyond what we need to maintain our pre-Singapore voting share" (Henry M. Paulson, Statement by the U.S. Treasury Secretary 2007b).
- Germany: Chancellor Schröder (2002) wrote: "After all, we need a truly democratic trade and financial regime in the world". By emphasizing an equality of rights following the UN-pattern of 'one country, one vote', Schröder's statement can be interpreted as a reflection of the *process idea* of consensual decision making in Germany.

- Germany: “Considerations should also be given to the role the quota formula should play in ensuring cohesiveness and equity between the Fund’s members. It should support a balanced distribution of quotas amongst all Fund members” (Federal Minister of Finance Peer Steinbrück 2007b).
- Germany: “Germany supports efforts to strengthen voice and representation of developing countries” (Federal Minister of Finance Hans Eichel 2004)
- Germany: “The quota and voting shares of the newly industrializing countries and of the developing countries shall be increased and the shares of the industrialized countries shall be reduced correspondingly“ (Bundesfinanzministerium (BMF) 2007)

### *Policy*

The International Monetary Fund was originally created in order to oversee exchange rates and grew into an organization which helped countries with balance of payments problems with short-term stand-by lending. The conditions attached to this lending aimed at improving the balance of payments situation of the borrower. The IMF’s role and financial involvement increased over the last 25 years especially with the respective crises in Latin America (1980s) and Asia (1997/98). The debate on a reform of the Fund’s policy essentially centers on whether it should focus on a surveillance of exchange rates and markets or whether it should be more involved in lending and regulation. The basic difference between German and U.S. positions refers to whether market forces should be trusted or embedded by the IMF and to whether the IMF should have a stronger or weaker role in governing the market and lending. Two quotes give evidence for the general difference in policy direction “trust in market forces” versus “regulation of markets”:

- U.S.: “For the IMF, we will seek to refocus it on its core mission: international financial stability. This means strengthening the IMF’s ability to monitor the financial system to prevent crises before they happen. If crises occur, the IMF’s response must reinforce each countries’ responsibility for its own economic choices. A refocused IMF will strengthen market institutions and market discipline over financial decisions, helping to promote a stable and prosperous global

economy. By doing so, over time markets and the private sector can supplant the need for the IMF to perform in its current role” (The White House: National Security Strategy 2006: 30).

- Germany: “More than ever we need cooperation with other states and international institutions in order to promote international financial markets in those regards in which they offer opportunities for growth, wealth and employment, but also in order to prevent uncalculable risks and economically damaging erroneous developments through effective surveillance and regulation [of financial markets]“ (Finance Minister Peer Steinbrück 2007a).

More specifically, the two countries differed with regard to whether the IMF should (1) be in charge of a surveillance of exchange rates or also of financial markets more generally; (2) stick to surveillance or engage in larger lending; (3) consider poverty reduction as part of its policy:

*(1) Surveillance: exchange rates/ financial sector.* The contentious issue with regard to surveillance is whether the Fund should focus on its core function of securing the stability of exchange rates and balance of payments through surveillance of exchange rates favored by the U.S. or whether it should expand its surveillance to the financial sector in general. The latter is supported by Germany and would increase the Fund’s influence not only on the international dimension of financial markets, but also allow it to rule into domestic regulation of markets:

- U.S.: “Exercising firm surveillance over members’ exchange rate policies is the core function of the institution. (...) This should enable firmer surveillance in areas where market forces are not the prevailing paradigm” (Henry M. Paulson, U.S. Treasury Secretary 2007)
- Germany: “Surveillance is the most important task of the Fund (...). We appreciate the efforts by the fund to strengthen the operational and analytical foundations of the surveillance of exchange rate policies. (...) We welcome the (...) step towards integrating macroeconomic and financial market analysis in multilateral

surveillance and towards focussing bilateral surveillance on financial sector issues” (Federal Minister of Finance Peer Steinbrück 2006).

- Germany: “It is particularly important that the Fund should bring its coverage of financial sector and capital market developments, including at the global level, to the same level as its other core areas of expertise in surveillance” (Federal Minister of Finance Peer Steinbrück 2007).

(2) *Lending: reduction of lending/ expansion of lending.* The U.S. government opposes lending by the IMF because it fears “moral hazard” and trusts market forces. Thus, the U.S. favors a restriction of IMF lending activities and a focus on securing stability through surveillance. In contrast, Germany considers lending a core task of the IMF also with regard to a recipient country’s domestic economic policy:

- U.S.: “Rather than responding to global developments by expanding its mandate and making its efforts more diffuse, we believe the IMF needs to adapt and refine its core mission of promoting international financial stability and balance of payments adjustment” (John W. Snow, Statement by the U.S. Treasury Secretary 2005).
- U.S.: “However, the responses of the international community to crises in the 1990s continued roughly the same fashion as the response to Mexico (...) They tended to be government-focused rather than market-focused, emphasizing large loans by the official sector and later government induced bail-ins by the private sector. Many observers became concerned that the increasing use of very large financial packages and the bail-ins were having adverse effects on expectations or incentives” (John B. Taylor, Under Secretary of the Treasury 2004).
- Germany: “In case of balance of payments difficulties the IMF can emburse credits and loans to its member countries in order to support their economic adjustment and reform policies. In this regard, the IMF will focus increasingly on considering the social effects of its measures and on poverty reduction“ (Bundesregierung/Bundestag, Declaration of the Federal Government to Parlament 2004: 19).

(3) *Poverty Reduction: not IMF task/ IMF task.* With regard to poverty reduction, the U.S. clearly opposes international “solidarity” through financial aid by the IMF, while Germany clearly wants the IMF to continue and to expand its poverty reduction activities:

- U.S.: “(...) the IMF is not a development agency, and we strongly concur (...) that the IMF’s financing role in low-income countries should focus on actual balance of payments needs as it does in emerging market members” (Henry M. Paulson, Statement by the US Treasury Secretary April 14, 2007)
- U.S.: “The IMF has an important role to play in low-income countries, providing policy advice and technical assistance in its core areas of expertise, and balance of payments financing, when needed. We welcome the IMF’s efforts to re-focus its engagement with low-income countries (...), but caution against the IMF’s over-reaching on longer-term development issues better suited to the multilateral development banks” (Henry M. Paulson, Statement by the U.S. Treasury Secretary October 20, 2007)
- Germany: “We support the introduction of a new shocks window within the PRGF [Poverty Reduction and Growth Facility] and of the Policy Support Instrument for low-income countries. Furthermore, Germany will contribute to the subsidization of the Fund’s Emergency Assistance for Natural Disasters” (Federal Minister of Finance Hans Eichel 2005).
- Germany: “PRGF arrangements remain the core instrument of the Fund to contribute to poverty alleviation (...). Germany supports a financially augmented self-sustained PRGF” (Federal Minister of Finance Hans Eichel 2004)

### *Result*

In sum, the preference of the U.S. government emphasizes different influence for those countries which fund the IMF and those who receive financial support by the IMF on the Fund’s decision-making. With regard to policy, the U.S. underlines individual responsibility as well as trust in market forces and the goal of reducing IMF programs to emergency aid. The German position shows less trust in market forces than the U.S.

position, wants international solidarity through an expansion of IMF programs on poverty reduction, and favors a strengthening of the developing countries in the decision-making of the Fund. Ideas as an independent variable allow a plausible interpretation of the diverging positions of the two governments. The preferences diverge along different content and process ideas with regard to “public solidarity/ individual responsibility”, “regulation of market/ trust in market”, and “inclusive decision-making/ leadership according to contributions”. The differences between the governmental preferences could not be overcome. No substantial reform of the IMF was achieved.

### **Domestic Interests and Governmental Preferences: The Basel II Accord**

Unlike the IMF, which aims at governmental policy making and only indirectly affects private companies, Basel II directly governs private business by setting standards for lending and borrowing and therefore by influencing competitiveness and costs of firms. The multilateral negotiations between governments on the Basel II Accord in the Basel Committee on Banking Supervision intend to reform the standards which banks must follow when lending capital. The goal is to systematically link the risk of lending to the reserve requirements for banks – the riskier the loan, the higher the reserves - in order to avoid problems for banks and financial market crises.

While Basel I determined reserve requirements according to the type of borrower, Basel II makes reserve requirements dependent on the individual creditworthiness of the borrower. The negotiations were conducted on the German side by the Bundesbank, the Federal Surveillance Office for Banks (BaFin) and on the U.S. side by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve System. Thus, unlike the IMF case the German Ministry of Finance and the U.S. Department of the Treasury did not participate directly in the negotiations, but oversaw and/ or controlled the negotiating governmental agencies mentioned above. In the two countries, the assessment of the creditworthiness of borrowers is traditionally undertaken in different ways following distinct national standards and procedures. A first look at the governmental positions shows that neither government recurs to “ideas” in their statements. Instead, the positions reflect the material interests, the costs and benefits of the economic sectors affected,



especially those of the banking community. Therefore, this case study seems well suited for an illustration of the influence of material interests articulated by lobbying groups. The lobbying activities of individual banks (such as Mellon and State Street) as well as bank and industry associations (such as the American Bankers Association and Bankenverband) have been widely reported in the media (see e.g. *The Economist*, March 29, 2003: 65-66; *Financial Times* October 19, 2002: 12 and June 17, 2003: 31 and June 19, 2003: 11 and October 15: 15; *Financial Times Deutschland* April 4, 2001: 20 and April 2, 2002: 32 and October 31, 2003: 1 and November 14, 2003: 22). The following quotes evidence both the demands of lobbying groups and the governmental positions on the Basel II issues. In order to reach a high representativity of the independent variable “interests”, only documents from associations representing the involved sectors such as the American Bankers Association, the Bundesverband Deutscher Banken and the Association of German Industry (and no positions of individual companies) were considered:

(1) *Affected Banks*. In the United States several lobbying groups pressured the government to apply the new Basel II rules only to large, internationally active banks. The U.S. government acceded to these demands. The question on which banks must implement Basel II was not a lobby issue in Germany (and the EU) because special standards were set for small and large banks, while all banks had to implement Basel II:

- U.S. Interest Group: “We support the concept that the New Accord should only be applied to the largest internationally active banks and others that elect to adopt its requirements. The complex standard is not appropriate to most small community banks.” (American Bankers Association 2003).
- U.S. Interest Group: “The original Basel Accord was developed (...) to provide a uniform international regulatory standard specifically for large, internationally active banks. The agencies, however, elected to apply it to every bank in the country. The generic model has never been a good fit for the wide variety of individual circumstances of American banks, particularly the smaller institutions”

(Harris H. Simmons, Testimony on Behalf of the American Bankers Association (ABA) 2006).

- U.S. Government: “Maintaining an appropriate competitive balance in the U.S. between our large, internationally active banks, on the one hand, and the thousands of smaller banks and thrift institutions, on the other hand, is the crucial consideration” (John Hawke, Testimony of the Comptroller of the Currency 2003, p. 3)
- U.S. Government: “As noted, we anticipate that only one or two dozen institutions would move to the U.S. version of Basel II in the near term, meaning that the vast majority of U.S. institutions would continue to operate under Basel I-based rules” (Blies, Susan Schmidt, Governor of the Board of Governors of the Federal Reserve System 2006).

(2) *Form of Rating*. U.S. banks traditionally use external rating agencies such as Moody’s and Standard & Poor in order to assess the creditworthiness of (potential) borrowers and are accustomed to be rated themselves externally. In contrast, German banks traditionally use internal rating mechanisms for borrowers with whom they traditionally have a long-term involvement as “Hausbank” of a company. Thus, the cost of adapting to the external rating planed in Basel II , was heavier for German banks than for U.S. banks: „German resistance against the exclusive use of external ratings is based on the argument that they would distort the level playing field“ (Kerwer 2004: 217; also see Wanner 2003: 22). German banks lobbied in order to maintain the option of internal rating and to ease the pressure of adaptation to external rating mechanisms. In the end, the negotiators agreed to include internal as well as external rating in the New Basel II Accord:

- German Interest Group: “Furthermore, we consider the strong restriction of the applicability of the Internal Assessment Approach (IAA) (...) not practicable. (...) It would contradict the systematic of Basel II to force the banks to implement an IAA according to the procedures of a recognized external rating agency, when this bank practices an internal risk assessment system” (Zentraler Kreditausschuss der Deutschen Banken 2004)

- German Government: “The banks can estimate all four risk parameters themselves. The resulting risk assessment system internal to the banks has to be approved by the supervising agency BaFin“ (Bundesministerium der Finanzen (BMF) 2006: 59).

(3) *Implementation Schedule.* U.S. banks heavily lobbied policy makers to delay the implementation of Basel II in the U.S. and to make the final implementation dependent on analyses and on first experiences of the effects the Basel II regulations would have on the competitiveness of U.S. banks. The success of this lobbying by U.S. special interest groups triggered opposition of German lobby groups who feared a distortion of international competition because German and EU banks had to fully implement Basel II regulations much before U.S. banks. German lobbying groups were also successful in shaping their government’s position on this issue:

- U.S. Interest Group: “ICBA remains concerned about the competitive disparities between Basel I and Basel II and recommends that the implementation of Basel II (...) be delayed until the U.S. regulators have completed their analysis (...) and have come to a consensus concerning its competitive impact” (Independent Community Bankers of America (ICBA) 2005).
- U.S. Government: “(...) the banking regulators announced a delay in the implementation of the phase-in period for Basel II, which will not begin until 2008, a year after European banks will begin implementing Basel II” (U.S. Department of Treasury 2006: Under Secretary of the Treasury for Domestic Finance Randal K. Quarles).
- German Interest Group: “(...) voices are heard from the U.S.A. that the American side might want to implement Basel II later. However, no time should be lost in accomplishing the project also in its planned international scale” (Manfred Weber, declaration of the executive director of the Federal Association of German Banks, in: Bundesverband der Deutschen Banken 2005).
- German Government: “(...) I observe with great concern that Basel II is implemented within the European Union, but at the same time one is starting to hesitate in the last second on the other side of the Atlantic. That was not the

intention of Basel II. Therefore, we have to talk about this with the American partners once more” (Chancellor Angela Merkel 2006).

(4) *Small and Medium Size Enterprises (SMEs)*. Special treatment for Small and Medium Size Enterprises (SMEs) was an important issue for German lobby groups because SMEs form a large group of the German Industry Association’s (BDI) members and are considered to be the “backbone” of the German economy. Heavy lobbying made the government negotiate special rating and lending conditions for SMEs in the Basel II Accord. SME demands were not an issue for US lobby groups on Basel II:

- German Interest Group: “(...) the proposed directive put forward by the EU Commission for the implementation of Basel II needs to be redesigned to cater better for the need of the SMEs. The objective must be that the markedly lower risk ballast for the small and medium sized enterprises (...) are given full consideration” (Bundesverband der Deutschen Industrie (BDI) 2004)
- German Government: “The Federal Government has taken care that EU directives are implemented in a favorable way for medium-size firms. In this regard, we accomplished an agreement on medium-size-firms in the international negotiations on Basel II” (Bundesregierung 2006)
- German Government: „(...) the medium size [enterprises] component which was carried through in the negotiations by Germany (...) benefits private individuals and SMEs” (Bundesministerium der Finanzen (BMF) 2006: 59)

### *Result*

The diverging preferences of both governments clearly reflect the different interests of those sectors directly affected by the new governance initiative. Bank and industry associations in both countries lobbied and apparently induced the respective governments to follow their positions. In the end, the Basel II negotiations reached a compromise on which both sides could agree: the use of external rating was complemented with possibilities of internal rating and the additional costs for long-term lending (traditionally stronger for German SMEs than in the U.S.) were moderated to a level acceptable to the

German side. The delay in implementation of Basel II in the U.S. and the kind of banks affected by Basel II in the U.S. are still under discussion. In sum, the core distributional conflicts were gradually solved in the negotiations by mutually acceptable partitions of the costs of adjustment to new governance rules. Even though some issues are still contested, negotiators have agreed on most elements of Basel II and therefore successfully created more efficient global financial governance. With regard to the two countries examined here, compromises were reached which took into consideration the interests of German and U.S. banks as well as the interests of all (banks and governments) in an increased stability of financial markets through new rules of global governance.

### **Conclusion**

Why do governmental preferences towards global financial governance diverge despite a shared perception of the need for a better management of globalizing financial markets? The explanatory approach outlined in this paper and the brief empirical exemplification of the hypotheses showed that the foreign economic policy preferences of governments were decisively shaped by domestic ideas or interests, which led to cross-country divergence. The plausibility of this result is based on the incorporation of material interests as well as societal ideas into the analysis. An exclusive consideration of one of these two variables would have allowed only for a partial explanation of national divergence. It was possible to show theoretically and empirically that the incorporation of both variables increases the cognitive value of the analysis of international political economy.

Why do governments agree on a reform of global governance in some cases, but not in others? The case studies supported the hypothesis that new governance succeeds more easily when differing interests come to bear than when diverging ideas meet. Differences in material interests were accessible to compromising through a partition of costs and benefits of new governance. On the other hand, divergence of ideas with regard to questions on the core tasks of politics towards markets (contents ideas) and on the

methods of political decision making (process ideas) were not as amenable to compromise. This second puzzle on the conditions for compromise confirmed the necessity of considering both variables in the analysis.

When do ideas prevail over interests and when interests over ideas? An important field for future research on the influence of endogenous factors on governmental preferences on global economic governance concerns hypothesis 3 regarding the examination of the reasons for the specific role of ideas versus interests. The conditions must be theoretically and empirically further analyzed under which ideas prevail over interests or vice versa in foreign economic policy. The results of the case studies presented here, however, provide evidence for a preliminary answer:

First, an important condition seems to be the *intensity* to which interests are affected and with which they are articulated vis-à-vis the government by lobbying groups. Domestic interests formed the dominant influence on governmental positions in the case in which organized interest groups were affected directly through changes in costs by the planned global governance rules and in which they were actively lobbying the government. On the other hand, ideas prevailed in influencing governmental preferences in the case in which no interest group was affected directly by costs and in which fundamental questions of the role of politics in governing the economy were debated. Thus, neither the German nor the U.S. position towards the Basel II negotiations were dominated by ideas, but both strongly reflected the interests of affected and active lobby groups. On the other hand, both governments' positions on the reform of the IMF clearly mirrored endogenous content and process ideas while no affected and active lobbying groups were observed. Apparently, the *global public bad* of a suboptimal management of financial crises by the IMF did not privilege or underprivileged specific interest groups to the degree necessary to mobilize intensive lobbying on a new strategy for the IMF. Thus, with regard to intensity, interests prevailed over ideas when special interests are strongly affected directly, while ideas prevailed when interests were affected only in a diffuse way.

Second, another condition decisive for the question on the prevalence of either ideas or interests is the *policy issue* at stake: does the global governance initiative concern fundamental questions on the role of politics in governing the economy, or does it concern the distribution of costs and benefits in specific areas? Evidence from the case studies support the claim that ideas bear the dominant influence on governmental preferences, when fundamental political questions are at stake, as happened with regard to a reform of the IMF. Here, the issues under scrutiny revolved around the role of the state and the market in governing the economy as well as the form of participation in decision making and thus about the contents as well as the process of policy. These issues apparently strengthened the influence of ideas on the preferences of the two governments. The other case study supports this explanation, because the issues at stake at the Basel II negotiations referred to specific material and distributive questions on banking standards, which apparently triggered strong activities by affected lobbying groups, which sought to promote their interests as key variables in the formation of governmental preferences. Thus, interests prevailed over ideas when distributive questions dominated, while ideas prevailed over interests when fundamental questions about the role of politics in governing the economy dominated the governance debate.

The separation of ideas and interests in this paper was of course undertaken for the purpose of analytical clarity. Human action and governmental preferences will often include elements of both driving forces. However, which of these two variables prevails in a given area does make a difference not only to analysis but also to governmental preference formation and to the future of global governance. All conclusions of this paper must remain preliminary in nature due to the small number of cases and to the short empirical exemplification of the hypotheses. The core result is that a comprehensive explanation of the preferences of governments and of their ability to compromise on global financial governance only becomes possible when the analysis goes beyond international institutions and regimes and includes domestic ideas and interests as major driving forces.

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