The Political Economy of International Financial Governance

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The OeNB recently organized a workshop on "The Political Economy of International Financial Governance" to analyze current trends in financial governance from both an economic efficiency and an institutional perspective. Following a discussion of controversial financial governance theories, a number of case studies were presented on current issues, including financial market integration in the EU, changes in private sector associational activity in global finance, the Basel II process, the governance of pension funds, the market for over the counter (OTC) derivates as well as financial literacy programs. The case studies highlighted the role that noneconomic factors play in financial governance mechanisms. With a view to developing more realistic models, further research and more case studies will have to be undertaken to broaden the empirical basis for theorizing financial governance.

Alternative forms of regulation such as self-regulation and co-regulation combined with the increasing role of nonstate actors in financial governance have received growing attention in the academic debate about the prospects for the international financial architecture. Given the associated potential repercussions on monetary and financial stability, this implies considerable challenges for central banks. Furthermore, the changing mechanisms of financial governance challenge the role and influence central banks have within financial governance systems. As financial governance is not only an important public concern but also a complex institutional issue involving actors and institutions that have different interests and pursue different strategies, contributions of other disciplines (political science, sociology, international political economy, legal studies, etc.) must complement economic analyses to provide a comprehensive assessment. In his introductory remarks, *Peter Mooslechner* (OeNB) accordingly argued in favor of an interdisciplinary approach that combines economic efficiency considerations of regulation with institutional considerations. The main intent of the OeNB workshop on "The Political Economy of International Financial Governance" (November 26, 2004) was to advance research into why particular mechanisms and rules of financial market governance have been put in place and why they take the specific forms they do.

The first two papers discussed theories of financial governance best suited to explain the driving forces behind global capital market liberalization and regulatory reform. In his paper "Theorising Governance in a Global Financial System," *Geoffrey Underhill* (University of Amsterdam) reviewed contemporary concepts of governance that are applied to the financial and monetary domain: *Economic* theories of governance, on the one hand, focus on the interaction of rational actors and on achieving optimal patterns of economic transactions. Hence, they represent a rather narrow conception of governance which assumes that the principal goal of governance is market-based efficiency. A main drawback of economic theories of governance is that they can only tell us about incentive structures for particular forms of regulation given certain preferences, but little about how these preferences emerge and how regulatory outcomes actually occur. On the other hand, *political economy* theories of governance, unlike their equivalents in economics, are in search of the linkages between the economic and the social, the political and the market. They demonstrate that the inclusion of political and social variables, particularly the interaction of social constituencies in the policy process across levels of analysis, can help us explain governance outcomes in a globally integrating economic space. The interdependency of politics and markets is usually depicted as a simple dichotomy: political power versus rational, self-interested markets. Against this state-market dichotomy, Underhill introduces the concept of a state-market condominium and applies it to the financial and monetary domain: change occurs simultaneously through the process of economic competition and the regulatory processes mediated by the institutions of the state. The state-market condominium model facilitates understanding of the role of "nonstate" private interests in driving the process of global integration. What we have seen is not so much a retreat of the state in the face of market forces (politics versus markets) but a transformation of the state in symbiosis with the transformation of economic structures. The creation of global financial markets was a political strategy by a state-market alliance of interests which became transnational in nature. Private preferences were converted, through state policy, into the evolving structure of global financial governance.

In her paper on the "Political Economy Approach to Financial Reform" *Susanne Lütz* (Open University of Hagen) discussed various leading political economy approaches to explain causes and patterns of financial governance reform. First, the "market actors capture the state" approach contends that financial liberalization allows market actors to broaden their sphere of activity in order to circumvent public policies that would impose regulatory costs on them. States, while competing for the most mobile segments of capital, lower their standards of safety regulation and end up in regulatory races to the bottom. Advocates of a second approach argue that by engaging in multilateral collaboration on the European or global level, states can reduce exit options of market players and regime competition can be overcome. Finally, the varieties of capitalism approach underpins non-convergence of financial systems and its regulatory framework, as it stresses that states and market actors join forces to defend national models of regulation. According to Lütz, none of these three perspectives completely captures the causes and patterns of financial governance reform. Alternatively, she draws on an actor-centered approach that accounts for the interrelationship of global market changes and changing preferences of domestic actors vis-à-vis regulatory solutions and for the fact that the globalization of finance disembeds those actors from the domestic political economy that benefit from market integration while champions of national idiosyncrasies are being left behind. By drawing on cases of regulatory change in Germany's capital markets and the banking sector, she shows that in Germany reforms were driven by a modernization coalition of foreign regulators, the federal government and those market actors who were most interested in open markets and in adapting to the global rules of the game. At the same time, German state governments, regional banks and small and medium-sized firms were eager to retain their niches.

This introduction to controversial theories of financial governance was followed by several case studies on the most recent issue areas: Financial market integration in the EU, changes in private sector associational activity in global finance, the Basel II process, the regulation and promotion of pension funds, the international derivatives market, and the proliferation of financial literacy programs.

While financial markets are usually seen as the vanguard of globalization, the market for financial services has been one of the slowest and most difficult areas to integrate within the European Single Market Project. However, after years of stagnation, financial market regulation in Europe made rapid progress at the end of the 1990s: Major milestones include the Financial Services Action Plan in 1999 and the introduction of the "Lamfalussy" procedure for EU decision-making in 2001 as well as its extension to banking and insurance in 2002. In his paper "Policy Entrepreneurship and Subterfuge in the Evolution of EU Financial Market Governance," *Beat Weber* (Oesterreichische Nationalbank) explored the characteristics and determinants of this invigorating policy process. He shows these developments to be the result of policy entrepreneurship of governments building coalitions with their national financial industries and using techniques of subterfuge to shape the regulation process for financial intermediation in their favor.

While there is a widespread perception that private sector actors and markets have gained influence as finance has become more globalized, there is no consensus on the character and strength of this influence or on its significance for patterns of inclusion and exclusion in the governance of global finance. For some, an expanded influence of private sector actors and markets promotes inclusion because it is an expression of an unleashing of more widespread individual initiative and choice and a loosening of the restrictive grip of the state. For others, it is detrimental to inclusion because it enhances control by an exclusive financial elite over global financial governance, allowing them to ignore state-based mechanisms of public accountability that have traditionally legitimized financial regulation. In his presentation on "The Significance of Changes in Private Sector Associational Activity in Global Finance for the Problem of Inclusion and Exclusion," *Tony Porter* (McMaster University) explored the role of private-sector associational activity in global financial governance. By drawing on this research, he challenged both these views and showed that there is tremendous variation in the character, strength and significance of private sector actors and markets across governance and regulatory problems and arrangements. In general this involves stronger and more complex relations of interdependence between private and public sector actors and has both positive and negative implications for the problem of inclusion and exclusion.

Governance arrangements of over-the-counter (OTC) derivatives are of particular interest as self-regulation and self-supervision feature very prominently in this area. In her paper "The Governance of OTC Derivatives Markets," *Eleni Tsingou* (University of Warwick) analyzed the extent to which the governance of OTC markets has become a policy issue and explains that two elements have prevailed in policy debates: (i) OTC derivatives are just another type of financial instrument and do not require special treatment, and (ii) best practice (as defined by the private sector) and private mechanisms of monitoring are both sufficient and effective. The governance of OTC markets essentially takes the form of monitored self-regulation and self-supervision. Yet derivatives arguably merit greater attention because they carry leverage and are increasingly used not just to hedge against risk but also to embrace risk. In this context, the paper argues that the governance arrangements of OTC markets show the ways in which the functions of regulation and supervision are changing: governance is shared among a transnational policy community of public and private sector officials, and private interests are internalized in financial policy processes.

In the course of the shift towards funded pension systems across European countries the specific mode of governance of occupational pension funds not only influences financial stability; it furthermore has important repercussions for the political economy of pension reform. *Stefan W. Schmitz* (Oesterreichische Nationalbank) investigated those implications for the case of occupational pension funds in Austria ("The Governance of Occupational Pension Funds in Austria and its Politico-Economic Implications"). Based on the empirical analysis of the Austrian reform of the *Pensionskassengesetz* he discusses the relationship between the corporate governance of occupational pension schemes, the politico-economic background of the bill, and the distribution of the burden of this particular reform. The structural dominance of shareholders can result in a vicious circle for beneficiaries, as it subjects the governance arrangements in place to protect beneficiaries in conflicts of interests with shareholders to substantial political risk.

In her analysis of Basel II ("Financial Governance, Private Agents and Financial Market Regulation: The Case of Basel II), *Vanessa Redak* (Oesterreichische Nationalbank) showed in how far Basel II has changed and will change – in the field of banking regulation – the relationship between public and private actors, between state and markets, thereby leading to a transformation of traditional regulation and governance mechanisms. In a step-by-step analysis of each of the three pillars of the Basel II framework and by relating the regulatory mechanisms in these pillars with other international trends in financial market regulation, Basel II is conceptualized within recent politico-economic settings in banking and finance.

Finally, *Martin Schürz* (Oesterreichische Nationalbank) ("The Idleness of the Poor: Financial Literacy Programs") brought to the fore the role of norms and values in financial governance by investigating current programs of financial education initiatives in the United States. Financial literacy programs that are provided by public authorities in alliance with private actors gain increasing attention in Europe as well, given that the financial marketplace of the 21st century has become more complex, and individual risk taking more significant. Yet surveys for the United States show that financial education initiatives have actually not been successful in increasing the financial literacy of the poor. Schürz interprets financial literacy programs as a mode of governance that aims at translating an economic problem (low income and high inequality) into a cultural one (attitude of spending too much and saving too little). Moreover, they are linked to a new welfare debate on asset building. Governments now require increased individual responsibility for financial well being. Autonomy is interpreted restrictively as freedom for individual choice, and financial education shall provide consumers with incentives to make correct choices.

The case studies presented at the workshop emphasized the role of non-economic variables in understanding the evolution of financial governance. They also stressed the difficulties of conceptualizing one specific model of financial governance that encompasses all mechanisms and driving forces of regulatory change. In order to arrive at models that better capture reality, it was concluded that on the one hand further research should be devoted to case studies to broaden the empirical basis for theorizing financial governance. On the other hand, as discussant *Brigitte Unger* (University of Utrecht) concluded, the term governance itself still needs clarification. A vast body of governance literature has led to a plethora of governance concepts and, therefore, a theoretical debate about the suitability of governance concepts should remain on the agenda.