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The revival of the nation-state? Stock exchange regulation in an era of internationalized financial markets

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**The Revival of the Nation-State?
Stock Exchange Regulation in an Era of
Internationalized Financial Markets**

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96/9

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Abstract

The debate on economic “globalization” suggests that the blurring of territorial boundaries shifts the power relations between nation-states and domestic market constituencies in favour of the latter. States have lost autonomy since policies are increasingly formulated in supranational or global arenas. Market actors may use their wider choice of geographic location in order to lobby for low regulated market environments. The paper seeks to differentiate this common view considerably. It argues that economic internationalization weakens the capacity of domestic market actors to engage in self-binding agreements that formerly had solved regulatory problems. Networks of interstate collaboration in turn lack the ability to monitor and enforce negotiated agreements. Both developments impose new duties of market supervision on the nation-state. Empirical reference is drawn from the stock exchange sector that went through a process of transformation which has led to an enhanced role of the nation-state in the model of sectoral governance.

Zusammenfassung

Die zunehmende “Globalisierung der Ökonomie” scheint das Machtgleichgewicht zwischen Politik und Wirtschaft zugunsten der Ökonomie zu verschieben. Nationalstaaten verlieren an Autonomie, weil Politik zunehmend auf supranationaler oder globaler Ebene formuliert wird. Marktteilnehmer hingegen nutzen ihren erweiterten territorialen Aktivitätsspielraum, um staatliche Regulierungen zu umgehen, die ihre Produktionskosten erhöhen könnten. Der Beitrag will diese Perspektive differenzieren. Argumentiert wird, daß ökonomische Internationalisierung die Fähigkeit zu kollektiver Selbstregulierung der Marktteilnehmer schwächt. Netzwerken zwischenstaatlicher Kooperation auf der anderen Seite mangelt es an Kapazitäten, die Einhaltung von Vereinbarungen zu garantieren. Beide Entwicklungen führen zu neuen Aufgaben der Marktüberwachung für den Nationalstaat. Als empirisches Fallbeispiel wird der Börsensektor präsentiert, welcher weltweit einen Transformationsprozeß durchlief, aus dem erweiterte Aufgaben des Nationalstaates im Modell sektoraler Steuerung hervorgingen.

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1 Introduction

The debate on economic globalization suggests that the blurring of territorial boundaries shifts the power relationship between nation-states and domestic market actors in favour of the latter (Cable 1995, Schmidt 1995). States experience both external and internal challenges to their autonomy. Since they delegate policy-making powers to supranational or even global arenas, they are less autonomous in the formulation and implementation of policies for their constituencies. Market actors, in turn, are usually seen as the profiteers of economic and political “deterritorialization.” They are able to combine the opportunities for broadening their economic sphere with the capacity to circumvent public policies that would impose regulatory costs on them. Consequently, states lose control of their policy instruments: they are “hollowed out” internally (Strange 1995). There is perhaps no other economic sector that fits this scenario better than the financial one. Driven by changing strategies of finance companies, by deregulatory movements of national governments and by increasing use of information technology, worldwide integration of financial, particularly securities, markets has been taking place since the mid-1970s. Economic integration has been partly facilitated and partly accompanied by the development of an increasingly dense network of interstate collaboration in questions of financial regulation. Thus, at the international level, nation-states are mere negotiation partners in questions of regulatory policies, while internally they are “hollowed out” by more mobile and more internationally based financial capital, which is playing them off against each other.

The argument that is to be developed in this paper will not completely contradict this scenario. However, it will differentiate it considerably, in particular with respect to the unconditional assumption that finance companies have been strengthened and the state has been weakened by internationalization. The argument here is twofold. *First*, it shows that financial internationalization puts market actors under increasing pressure to compete and thereby erodes their

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previous capacity for collective action. Thus, market participants are no longer able to engage in the self-binding agreements that formerly had solved crucial problems of financial regulation. *Second*, economic integration has been accompanied by growing interstate collaboration in regulatory matters that attempts to cope with the cross-border risks of financial business. Both developments – the weakness of financial firms in regulating themselves and the growing importance of the international system in securities regulation – impose new regulatory duties on the nation-state. Thus, the state “is brought back in” (Evans/Rueschmeyer/Skocpol 1985) to the model of sectoral regulation. As “upholder of the law” the nation-state monitors and enforces the new rules of the global game. The present paper elaborates this argument through analysis of the stock exchange sector, particularly in Germany. Traditionally, this sector had been governed by a well-established mode of self-regulation with the state playing a minor role. During the 1980s and 1990s, this sector experienced a process of global transformation which has led to an enhanced role of the nation-state in the system of sectoral governance. Apparently, financial internationalization has shifted the domestic balance between private and public governance mechanisms in favour of the latter.

The following section discusses problems of financial regulation and elaborates on the preconditions which made the public and/or private provision of collective goods possible. It is argued that under conditions of open markets the domestic basis for cooperative solutions to regulatory problems is subject to erosion. The next three sections present the empirical case of the German stock exchange sector and reveal the causal mechanisms of its transformation. Finally, the argument for an apparent “revival” of the nation-state is qualified, and problems that evolve out of new state functions are discussed.

2 Mechanisms of Sectoral Governance and Financial Internationalization

Systems of capitalist production are not simply defined by free markets and private property. Market coordination is embedded in a regulatory framework which, by making it possible to avoid or circumvent problems of collective action, produces collectively beneficial outcomes. There are market failures of different types that regulatory structures remedy. *Negative externalities* arise when the well-being of a consumer or a firm is directly affected by the actions of another. Banking failure for example, may cause chain reactions which threaten to harm not only depositors but also institutions of other economic sectors. *Asymmetric information* between sellers and consumers of economic services about the quality of products is seen as another failure of the “invisible hand.” For consumers of fi-

nancial services it is very hard to tell directly whether their broker is offering honest advice or whether their principal banker maintains adequate margins of solvency. The better informed professional is very likely to engage in opportunistic behaviour and to take advantage of his greater access to information than a non-insider (see Herring/Litan 1995 and Kay/Vickers 1988 for problems of financial regulation).

In the face of these well-known shortcomings in the capacity of markets to provide collective goods, efforts have been made to develop alternative mechanisms to meet these demands. The *state* in particular is usually considered to be the primary alternative source of social and economic order. Even neo-classical economic approaches (see for example the economic approaches of regulation, Stigler 1975; Peltzman 1976) accept the state as the primary source of law. As the holder of a “monopoly on the legitimate use of violence” in its own territory it creates, monitors and enforces regulatory policies vis-à-vis its constituencies.

Nevertheless, failures of public regulation are at least as likely as those of markets. In response to this, institutionalist approaches dealing with problems of “industrial order” or “modes of sectoral governance” (i.e. Hollingsworth/Schmitter/Streeck 1994; Campbell/Hollingsworth/Lindberg 1991) emphasize that *self-regulation* of market actors may contribute a further source of social order that complements or even substitutes for the state. When industrial or financial firms manage to establish collective, mutually binding agreements, committing them to maximize joint gains instead of individual ones, these outcomes are known as “solidaristic,” “categorical” or “club-goods” (Streeck/Schmitter 1985, Buchanan 1965) because they leave at least the payers better off than before (see, for instance, the broad literature on the benefits of interfirm collaboration, Powell 1990, Powell/Smith-Doerr 1994; Lütz 1993). German banks, for instance, have established a collective system of deposit insurance protection, which is carried and managed by peak banking associations (see Ronge 1979). Stock exchanges operate an array of self-regulated committees that guard against misbehaviour on the part of exchange members (Insider Commission, Arbitration Tribunal).

Research on problems of collective action, however, has shown that smaller groups are organized more easily than larger ones (Olson 1968) and that one cannot always assume that associations will be capable of effectively representing the interests of their members. In fact, institutionalist approaches indicate that self-organized order comes about only under specified conditions, in particular, when the state retains sufficient strength to ensure that collective entities act in a broader public interest (Streeck/Schmitter 1985). Moreover, the debate on “neocorporatism” has shown that, under certain preconditions, state and private collective actors may engage in mutually advantageous exchange relationships. The state can help solve collective action problems within important interest associa-

tions by delegating its authority to legitimately coerce and thus enjoy a public status. In turn, associations may participate in processes of political decision-making and implementation. Both sides profit from this arrangement: the state is able to shift the burden of policy implementation to the side of market actors, whose participation may lead to greater flexibility and legitimacy of public policies. Associations or private collective entities, on the other hand, engage in self-binding agreements, but enjoy considerable autonomy in determining the level of cost they are willing to bear for the sake of their collective good. Even though corporatist systems had their shortcomings,¹ they were for a long time considered to be intelligent institutional arrangements allowing the production of collective goods on the macroeconomic or the sectoral level.

With the golden age of macrocorporatism now apparently over, can we assume that sectoral mixes of public-private governance have also come to an end? There are good reasons to believe so. The coupling of distinct public and private mechanisms of social order is only practical if both partners share the same ability to make autonomous and effectively binding decisions on behalf of their own constituencies. The *nation-state* requires the independent capacity to decide which kind of politics should be imposed on its constituencies. Autonomy in decision-making is a precondition for the capacity to share it with societal actors. *Associations or other types of collective entities*, on the other hand, have to ensure that their members abide by self-binding agreements and do not free-ride on them. Both of these preconditions depend on the assumption that the costs and benefits of public-private partnerships would be shared among a group of actors demarcated by *territorial borders*. Private collective entities need to control the exit-options of their constituencies in order to be trustworthy negotiation partners. The state, for its part, needs autonomy in the case of self-organizational failures among its constituent citizens, in order to be able to find and impose collectively binding solutions.

The current debate on *the globalization of the economy* contends that these conditions are no longer given. Globalization is mostly used as a fashionable, mystic keyword that indicates the process of blurring boundaries between formerly separated domestic product and capital markets. In general, it is very doubtful whether truly global markets are now replacing old and territorially demarcated ones. Even financial markets and, in particular, securities markets, which are often considered as the prototypes of the evolving “end of geography” (O’Brien 1992) in financial business, are not “global” in the sense that prices for similar assets are the same across markets. Important differences in trading procedures re-

1 Offe has pointed out that only organizationally privileged groups enjoyed the benefits of corporatist intermediation while less organized interests fell behind, giving rise to legitimacy deficits (Offe 1984).

main between markets and only few securities are traded in broad, liquid markets in more than one country. But even though truly global markets have not yet materialized, there is little doubt that in recent years both financial and securities markets have become increasingly internationalized. There is clearly greater interdependence of yields across not only instruments but also financial centres and in the regulatory frameworks in which market transactions are embedded (OECD 1995b: 16). In other words: the choices and strategies of public and private actors in financial business are more than ever framed by the opportunities and restrictions provided by the global economic and political landscape. The pessimistic scenario that follows from these developments can be characterized in the following way.

Nation-states experience two broad challenges to their autonomy. First, *externally*, in more and more policy fields it has become obvious that the state no longer has the autonomous capacity to formulate and implement policies towards its constituencies. Regulatory policies, for instance, are increasingly formulated in supranational or even global arenas with nation-states cooperating in multi-layered systems of decision-making. Problems like the degree and level of regulation, whether regulatory tasks are delegated to private actors or remain in the state's jurisdiction, are no longer solved by sovereign decisions, but have become objects of bi- and multilateral negotiations. Whilst the growth of regulation in the European Union is the most cited example of the growing role of supranational arenas of decision-making,² international regimes (Krasner 1983; Kohler-Koch 1989), with national representatives bargaining about levels and types of regulation, play crucial roles in policy fields like finance and environmental policy.

Second, *internally*, the state is said to be "hollowing out" (Strange 1995) since it no longer has sufficient control of the necessary policy instruments. If market actors carrying capital, production facilities and jobs increasingly decide to choose the exit-option in regard to their domestic territory, the effectiveness of national policies in preventing this is limited. With the dismantling of capital exchange controls at the end of the 1970s, for instance, the capacity of states to pursue macroeconomic management strategies has been reduced considerably (Webb 1991; Pauly 1995). Moreover, firms acting as global players may pursue strategies of regulatory arbitrage, by playing states off against one another and then settling in the one with the least intrusive regulation. The simple fact that there is a

2 Majone has shown that it was only in the field of environmental protection that almost 200 directives, regulations and decisions were introduced by the European Commission between 1967 and 1987. With the launching of the Single Market program in 1985, several hundreds of regulatory measures were proposed concerning different policy fields (Majone 1994: 85–86).

“disjuncture between the formal authority of the state and the spatial reach of contemporary systems of production and finance” (Held/Mc Grew 1993: 268) leaves market actors with more bargaining power than before in decisions about the adequate institutional framework of production and finance.

While the nation-state is obviously restricted in its capacity to impose autonomously binding decisions on its constituencies, it is very doubtful that this loss will be compensated for by a higher degree of self-regulatory capacity among market actors. Although the governance debate has not yet dealt with this problem in detail, it is clear that increasing domestic and international pressures in price and product competition, often initiated or catalysed by the deregulatory or competition policies of national governments or the European Union, *impede collective action at the national level*. In sectors most closely tied to the global economy, market actors will have greater difficulty reaching collectively binding agreements and enforcing them effectively. Global players will prefer the exit-option from binding pacts at home, particularly if these impose additional costs on production processes and products while possibly weakening their competitiveness abroad. Firms that are still oriented towards the domestic market, however, will face increasingly smaller profit margins and cut-throat competition. In sum, it is entirely possible that deterritorialization will lead to a growing heterogeneity of interests among the members of collective entities. A firm's willingness to cooperate in the provision of collective goods at home now depends increasingly on its capacity to benefit from the internationalization of markets: potential losers will tend to stick to collectively binding pacts while territorial boundary spanners will prefer to exit them. As a consequence of the increasing difficulties of interest aggregation, collective entities will face predominantly *internal* pressures of erosion.

Taken together, this pessimistic scenario of a “weak” state and “weak” collective actors suggests that state-sanctioned self-regulatory governance will be more and more unlikely in the face of economic and political internationalization. The following section will confront this pessimistic hypothesis with empirical data.

3 The Old Model of Sectoral Governance – Self-Regulated Cartels

Stock exchanges are among the most controversial institutions of the financial sector. Their opponents have complained about their character as “gambling places,” seducing unprofessionals to casino-like speculation, while their defenders have emphasized their role as ideal typical markets for capital, where supply and demand for securities are aggregated and are allocated at optimal prices. Today, it is the latter, more “rationalized” view of stock exchanges which dominates

the scene, although the technical opportunities for speculation have increased since the 19th century, as have the cases of speculative failures. It is due precisely to failures of the invisible hand's operations that stock exchange transactions have become embedded in a regulatory framework which distinguishes them from unregulated market arenas such as offshore tax havens or electronic equity trading via private firm networks. Although in theory formal rules provide for the proper operation of stock exchanges, it is important to consider the intensity of regulation or the degree to which rules are set by public law or by market actors themselves. In fact, one of the most distinct traits of stock exchange regulation traditionally has been its private, self-regulatory character. The American and the British systems have long been prototypical examples of this model of self-regulation (see, for an overview, Stonham 1987; Sobel 1994; Moran 1991, 1994; Coleman 1994 and 1996). Originating in the 1790s, the New York Stock Exchange (NYSE) and the London Stock Exchange (LSE) developed essentially as cartels of stockbrokers or investment houses, banding together by price-fixing (for example by means of the principle of noncompetitive commission fees for services rendered by members to nonmembers). Somewhat ironically, the "icons" of capitalism operated as exclusive clubs, creating high entry barriers to membership while internally maintaining control over their members.

In *Germany*, the modern stock exchange developed about 100 years later than in London or New York, although local fairs, serving as meeting places for the exchange of goods, information and securities existed as far back as the 16th and 17th centuries. The institutionalization of the stock exchanges was closely linked with the incorporation of the merchant class. Organized markets were mostly implemented by local chambers of commerce and enjoyed the status of public law bodies. Trading was governed by rules that were embedded within professional ethics of the merchant business. Internally, the exchanges were governed by a number of self-regulating committees which dealt, among other things, with admission to security listings, with fees for equity trading or with disciplinary procedures when exchange rules were breached (Insider Commission, Court of Honour, Arbitration Tribunal). It was mostly the "producers" of financial services, that is issuers of equities, stockbrokers and, in particular, the large universal banks, which held the majority of seats in these self-governing committees; individual investors had no voice in them.

The severe economic crisis (*Gründerkrise*) of 1873, followed by the stock market crash of 1891 – both of which brought severe financial losses to the broader public – spawned a debate over whether to tighten the mode of sectoral regulation in securities trading by including the state in the supervisory structure. The culture and practice of self-regulation was vehemently defended by the stock exchange members, and in the mid-1890s the German provincial governments (*Länder*) be-

came their strongest allies. Turf battles over the distribution of regulatory authority ensued between the federal government and the majority of the member governments. Ultimately, the Länder were the winners in this conflict: in 1896 they took over legal supervision of their respective stock exchanges and appointed “State Commissioners” to oversee the implementation of federal and state law. However, the Länder restricted themselves to a form of legal supervision over their respective exchanges and, by granting licences for self-regulation to private actors, basically practised a politics of non-intervention. This policy was continued after the Second World War, when eight regional stock exchanges were re-established and the Stock Exchange Legislation became part of Art. 74 of the German Basic Law. The regional governments were granted codecision rights over stock exchange matters which allowed them to bargain in the Federal Council (*Bundesrat*) over the approval of new legislation. The Federal government, that is, the Ministry of Finance, only played a minor role in this model of sectoral regulation. The Ministry had to share legislative competences in matters of capital market and particularly stock exchange legislation with the Länder. The framework of federal law had no significant provisions for a federal role either in sectoral supervision or in the regulation of behavior.

Sectoral self-regulation, tolerated by the federal government, was accompanied, if not made possible, by *cartel-like relations between stock market actors*. Firstly, cartel-like relationships evolved out of the dominant role German universal banks played in the model of sectoral governance. Unlike their counterparts in Anglo-Saxon countries, German universal banks were allowed to engage in both commercial and investment banking. Since they were able to fulfill the industry’s needs for capital either by providing loans or by issuing and trading their clients’ equities, they were the core financial intermediaries in the German financial system. However, it is common knowledge that their commercial banking operations were for a long time the more profitable kind of the two types of business. Issuing and trading customers’ shares was only a further element of the close relationships between house banks and industry.³ From this followed that capital markets were underdeveloped and the banks themselves held the majority of industrial shares in domestic stock markets.⁴ Between 1982 and 1992, for instance, the Deutsche Bank alone issued 52% of all newly listed shares on the German

3 In fact, researchers into the German economy have been eager to demonstrate that close, loan-based relations between banks and industry were the core of the German model of “organized capitalism” (Hilferding 1910) since they guaranteed overall stability for long-term industrial investment as well as for the economic system as a whole (Shonfield 1965; Dyson 1986).

4 According to the estimates of financial experts, only 20% of the capital of all German companies was traded on stock exchanges in 1992 while in Great Britain or in Switzerland the percentage share was about 80% (Die Zeit, November 27, 1992: 23).

stock exchanges (*Die Zeit*, November 27, 1992: 23). Restricted competition for industrial clients, therefore, was simply the outcome of the banks' structurally based position of power in the German financial sector.

Secondly, cartel-like relationships characterized not only the relations between members of one exchange, but also inter-exchange relations. Like their Anglo-Saxon counterparts, German exchanges systematically limited competition, but in Germany this was achieved through the system of German federalism. There were eight regional exchanges in Germany, with half of them generally trading in specialized shares of a regional character (Bremen, Hamburg, Berlin, Hanover) and only the larger exchanges (Frankfurt, Düsseldorf, Munich, Stuttgart) competing for the most liquid and therefore most attractive "blue chips."⁵ Despite obvious power differentials – Frankfurt alone covered almost 75% of all stock market trading in 1990 – a stable pattern of collaboration governed inter-exchange relationships. This was most visible in the internal structure of the Federation of Stock Exchanges. The Federation was a common working group, founded in 1952, to deal with significant problems associated with rebuilding capital markets after World War II. Internal decision-making procedures were characterized by chair rotation and a consensus rule, both of which clearly indicated equality among the membership. Stable inter-exchange collaboration, however, was the basis for the survival of the weaker partners of the circle. Part of the circle's "unwritten rules," for example, was that some of the most attractive shares had to be traded at all exchanges. This, in turn, required large industrial issuers to apply for trading at all eight sites and pay all the related fees. From the viewpoint of the smaller trading places, this rule subsidized their further existence and also guaranteed that smaller firms, whose equities were unlikely to be traded in Frankfurt, might use their home exchange to go public. Although the large German banks were mostly oriented towards Frankfurt, where the largest turnover of the most liquid shares took place, they nevertheless upheld the regional market structure. There were basically two reasons for this: first, due to the different sizes of the regional exchanges, price differentials for certain shares came about that provided arbitrage opportunities for banks. The second, probably more important, reason was that, as long as equity dealing played only a minor role in German finance and as long as banks dealt mostly with domestic and not foreign investors, they could easily shift the costs for subsidizing their weaker exchange partners to the customer, i.e. investor, side. As a result, costs for the clearing and settlement of deals, brokers' commissions and turnover taxes were higher in Germany than in other countries. German individual investors, however, did not complain about this. In fact, they have traditionally preferred bonds, bank deposits or life

5 In Germany, the 100 most liquid shares are part of the German share index (the DAX).

insurance contracts to riskier investment in equities. Moreover, a far-reaching pension fund system discouraged the growth of large institutional investors like insurance companies, pension funds or mutual funds in Germany. Therefore, on the domestic market, a strong lobby of investors as existed in the United States was lacking.

Taken together, the German model of sectoral governance resembled *self-regulated cartels embedded in the system of German federalism*. Stock market actors and regional governments were joined together by the common interest in defending their sphere of influence against intervention by the federal state. In particular, Länder and market actors built strong coalitions against efforts to penetrate the model of regional self-regulation, through such measures as the incorporation of regulatory matters into federal law or the establishment of a federal supervisory agency. The Federal Ministry of Finance, for example, experienced strong resistance from these regional coalitions in the mid-1960s when it tried to raise standards of investor protection, to criminalize insider trading and introduce further disclosure rules. The reform was intended to render shareholding more popular among investors and to build trust in organized capital markets. In the face of this opposition, the reform initiative ended with only incremental success: the coalition of market actors and the regional governments proved itself able to ward off intrusion from the federal government. Since then, a state of friendly co-existence has characterized the relationship between market actors and the federal state. As long as the sector was not shaken by crises or by external threats, the Federal Ministry saw no reason for intervention. Instead, it relied on the capacities of market actors to handle problems of sectoral regulation by themselves.

For market actors, in particular *for German banks*, the model of sectoral self-regulation was a very comfortable one since it provided low regulatory efforts. Since primarily the universal banks controlled the majority of seats in the self-regulating committees of the exchanges, in effect the community of producers of financial services themselves decided on the costs they were willing to take for the sake of the transparency and openness of their market transactions. Not surprisingly, regulatory standards designed to overcome problems of asymmetric information between the sellers of equities and investors stayed quite low. Even after the reform initiative of the Federal Ministry, insider trading was not criminalized nor were disclosure rules allowing transparency over the issuance, registration and trading of securities established. It was the producers' own rules that governed trading activities, and since investors lacked a strong domestic lobby, they had no other choice than to trust in the functioning of self-regulation.

In sum, an economic cartel of sectoral governance was accompanied by a political one, and both were based on the same preconditions: on the relative unimportance of the investor in the stock market, and on the fact that the German big

universal banks, as the actors who dominated stock market business and also the politics of sectoral regulation, supported it. We shall see that, at the end of the 1980s, these conditions no longer existed.

4 Mechanisms of Internationalization and Their Implications for Domestic Actors

Within the last two decades, financial markets have experienced a period of fundamental transformation. The nature of the securities business in particular has turned from a highly regulated, tradition-bound activity somewhat on the fringe of most financial systems into the primary force changing the financial landscape of the OECD countries. Two broad structural developments have characterized this transformation: first, increasing *competitive pressures* evolving out of the blurring of domestic market boundaries and a structural change in the finance sector that favours investment banking over commercial banking; second, increasing *interstate collaboration in questions of financial regulation*, driven mostly by the states' desire to prevent the cross-border spread of risks.

The blurring of market boundaries has been spurred by the changing strategies of financial market actors, by the use of information technology to exploit arbitrage opportunities on a worldwide scale and by the deregulatory activities of national governments. Deregulation started with the abolition of exchange controls in the late 1970s. Domestic governments allowed financial innovations to be traded, lowered access barriers for foreigners to stock exchange membership and replaced former price cartels by systems of negotiable commissions for brokers and traders (for an overview see OECD 1995b, Cerny 1993b, Laurence 1996). By the early 1980s, cross-border flows of capital had reached enormous volumes, and the issuance and trading of securities on international markets burgeoned (see table 1).

The transformation of financial markets, however, consists of more than a simple territorial expansion in activity. Probably the most important structural change is that an increasing share of financial intermediation is taking place through capital markets as opposed to bank lending. Banks as the classical financial intermediaries are increasingly bypassed by borrowers and put under competitive pressure by institutional investors. Borrowers, especially those who are credit-worthy, prefer to transform their liabilities into tradable securities since this is a much cheaper way of raising capital than relying on bank credits. By direct recourse to investors in the capital market, borrowers tend to replace the interme-

Table 1 Cross-border Transactions in Bonds and Equities^a (as % of GDP)

	1970	1975	1980	1985	1990
USA	2.8	4.2	9.3	36.4	92.5
Japan	n.a.	1.5	7.0	60.5	118.6
Germany	3.3	5.1	7.5	33.9	57.5
France	n.a.	n.a.	8.4 ^b	21.4	53.3
Italy	n.a.	0.9	1.1	4.0	26.7
UK	n.a.	n.a.	n.a.	367.5	690.1
Canada	5.7	3.3	9.6	26.7	63.8

a Gross purchases and sales of securities between residents and non-residents.

b 1982.

Source: BIS 1992

diary function of banks (= “securitization” of financial relations). Institutional investors, on the other hand, have turned into the major players on internationalized securities markets. During the last 15 years, insurance companies, pension funds or mutual funds have experienced a considerable growth and play an ever-increasing role as collectors of savings, major owners of publicly held companies and as investors in securities and other financial assets (see table 2).

Their power is based on the fact that institutional investors are mostly multinational firms which tend to diversify their portfolios internationally and operate with large blocks of the most liquid shares in the world. Therefore, institutional investors have gained the potential to take advantage of the differences in costs and returns across national markets. They choose from among the most innovative, but particularly most price-sensitive, trading places in the world (Rasch 1993: 15–16; Gerke 1995).

Taken together, worldwide structural changes in securities markets have shifted power from the producer of financial services to the customer, in particular to the investor. For commercial banks (or universal banks which have traditionally relied more on commercial banking than on the investment business) this is a relatively new experience, given the fact that credit-based relationships are usually dominated by the creditor. Yet, commercial institutions see themselves increasingly bypassed by the most attractive borrowers and left behind with smaller, probably less credit-worthy firms. Institutional investors, on the other hand, have gained bargaining power with regard to transaction costs they are willing to pay and with regard to the level of protection offered to them.

Table 2 The Size and Growth of Institutional Investors

OECD Region	Compound average annual rate of growth			Total assets out- standing at end 1991 in billion US \$
	1981–1991	1981–1986	1986–1991	
Life Insurance Companies				
Europe ^a	15	9	22	1,200
North America	12	12	11	1,700
Japan	24	25	22	1,100
Total	15	14	17	4,000
Pension Funds				
Europe ^a	15	17	13	1,300
North America	16	18	13	3,300
Japan	23	26	19	300
Total	16	18	14	4,900
Investment Funds				
Europe ^a	25	31	19	1,000
North America	19	24	14	1,400
Japan	26	44	10	300
Total	22	28	15	2,700
Growth of All Institutional Investors				
Europe ^a	17	17	17	3,500
North America	15	17	13	6,400
Japan	24	29	19	1,800
Total	17	18	15	11,700

a The ten European countries taken into account are: Austria, Finland, France, Germany, Italy, Netherlands, Spain, Sweden, Switzerland and the United Kingdom.

Source: OECD 1995c

The emergence of an increasingly dense network of regulatory *interstate collaboration* is the second important feature of internationalized securities markets. Collaboration entails negotiations on the harmonization of supervisory standards and on cross-border contacts between domestic regulatory bodies aimed at monitoring and enforcing rules. Interstate cooperation is practised on the *bilateral* as well as at the *multilateral* level. Bilateral Memoranda of Understanding (MOUs) between domestic regulatory agencies have until recently been the predominant form of regulatory coordination in the securities sector. MOUs tend to be highly

technical and fix the rights and duties involved in the exchange of information between different regulatory bodies. They also provide for mutual assistance in the investigation of securities law violations.

Multilateral coordination on matters of securities regulation took place at the level of the European Union whose “Single Market Programme” of 1985 considerably pushed the integration of European capital markets. Particularly the directives on “Insider Trading” (89/592/EEC of November 13, 1989) and on “Investment Services” (93/22/EEC of May 10, 1993) aimed at generating a network of collaboration between regulatory bodies of the member states. Both directives link the creation of a Single European Market for securities with the principle of *home country control*.⁶ That is, they require member states to specify a supervisory body for the securities sector, which would then cooperate closely with its foreign counterparts. Further coordination takes place in the International Organization of Securities Commissions (IOSCO), an international regime of national regulatory bodies (see for the IOSCO: Coleman/Underhill 1995; Porter 1993; IOSCO 1994). IOSCO was founded in 1974, first as an inter-American organization, and in 1984 reorganized into an international body, representing domestic securities and exchange commissions. During the 1980s, IOSCO was transformed more and more into a global platform for coordinating and harmonizing regulatory standards.

In the mid-1980s, both structural changes sketched out above created pressures to reorganize domestic systems of sectoral governance. Starting with the United States, a worldwide process of domestic financial marketplace restructuring was set in motion (for an overview see Moran 1991, Coleman 1996, Laurence 1996). Reorganization partly aimed at modernising stock exchange trading, for example by using electronic trading systems and by offering an array of new product innovations, and was therefore closely linked to the deregulatory efforts mentioned above. It was not only the market itself which was the object of reorganization. The regulatory framework in which market activities were embedded also underwent profound transformation. Probably the most distinct feature of the financial services revolution was that liberalization of market activities was accompanied by a tightening of the rules of investor protection (see on the general point of freer markets and tighter rules: S. Vogel 1996). Systems of stock exchange governance underwent in a large number of industrialised countries a process of “institutionalization, codification and formalization” of rules (Moran 1991) together with a strengthened role of the state. Either regulatory tasks were dele-

6 This principle is common in the field of financial regulation; it was used in international agreements on banking issues both by the Basle Committee and the EU-Commission (see Kapstein 1994).

gated to newly founded independent agencies like the *Commission des Bourses* (COB) in France, or regulatory activities were increasingly embedded in public law as in Britain.

In this process of sectoral reorganization, the United States played a crucial, even *hegemonic* role.⁷ Hegemony refers in this case to the coupling of market-power and political power in the international arena (see also Strange 1986 for the leadership of the US in international finance). Market power arises from the fact that the largest institutional investors, actors who have turned into the major players on international securities markets, are located in the United States. Between 1955 and 1975, institutions became major shareholders of securities on the New York Stock Exchange and used their position of structural power to erode the former price cartel of domestic investment firms by claiming discount prices for the trading of large blocs of shares. Moreover, crises following from the breach of trading rules and substantial losses of investors led to a debate about the shortcomings of the existing system. In the 1970s, insider trading became an issue of the regulatory debate and, in the mid-1980s, a campaign against insider-dealing led to enlarged supervisory powers for the Securities and Exchange Commission (SEC) over domestic stock exchanges (Moran 1991). With their size and importance steadily increasing, American investors were able to extend their influence over foreign countries. Since they are considered to be most the most attractive customers, their wishes drive the strategies of foreign producers and regulators (see Laurence 1996 who argues that “mobile” consumers are the general beneficiaries of regulatory reforms in finance).

The political power of the US derived primarily from the power of the Securities and Exchange Commission (SEC), which is considered to be the world’s most reputable “watchdog” organization in securities markets. The power of the SEC is due not only to the fact that it is the oldest regulatory agency in the securities sector, but also because its mission is focused on the protection of investors. The SEC upholds a regulatory model that is seen as the most investor-oriented one in the world. Given the fact that this model imposes the highest costs in terms of disclosure rules and transparency standards on its domestic producers, the SEC has a strong interest in exporting it. Under conditions of increasingly internationalized markets, high regulatory standards could have turned into competitive disadvantages for US investment companies. This was exactly the reason why the SEC began working on the expansion of collaboration between domestic regulatory agencies at the beginning of the 1980s. It was especially the instrument of

7 In contrast to Laurence (1996), Moran (1991) has clearly shown an active role of the US in the process of sectoral restructuring, and the German case will prove a further example of this.

bilateral Memoranda of Understanding (MOU) that the SEC used to export its regulatory model abroad. The core of these bilateral contracts is to ensure *reciprocal assistance from the foreign regulatory agency in cases of cross-border fraud*. This could entail, for instance, conducting investigations at the request of foreign agencies or to obtain documentary evidence from abroad. This kind of reciprocal exchange between two international watchdogs, however, is much easier if both are public authorities with the same competences and the same kind of autonomy from their market constituencies. If, for instance, a foreign financial firm has violated a domestic securities law, the domestic regulatory body can ask its foreign counterpart for “legal assistance.” This can often create significant problems in the absence of a public regulatory body: private associations, for example, could have great difficulty in lifting the domestic bank secrecy veil. In turn, reciprocal exchange between regulatory bodies also demands that information obtained is kept secret. A private agency such as a banking association with self-regulatory powers appears to be a less trustworthy partner in exchanges of business secrets since these could be leaked to the association’s members. Thus, signing a MOU with the SEC imposes, more or less, direct pressures on the foreign counterpart to level its domestic system of sectoral supervision in line with US standards. Starting with Switzerland in 1982, Great Britain and Japan in 1986, the Canadian Provinces and Brazil in 1988, the Netherlands in 1989, and France and Italy in 1991, the SEC had signed as many as 20 MOUs worldwide by 1994. In almost all of these countries, MOUs with the SEC either preceded the establishment of new public regulatory agencies or followed shortly afterwards (see Moran 1991: 118 for the SEC’s role in promoting the re-regulation of the Japanese financial market, and see Smith 1988, Bernhard/Blumrosen 1993, Baumgardner 1990, US SEC 1994 for MOUs in general).⁸

Taken together, US market and political actors were strong allies in matters of investor protection. The linkage of investors’ market power and of the SEC’s capacity to create a regulatory model for investor protection worthy of imitation by other countries was the key force in this regulatory “race to the top.”⁹

8 Nadelmann (1993) has argued that the SEC’s strategy was part of a broader internationalization of US criminal law enforcement during the last five decades. The US has played a central role in the evolution of a transnational police community by advocating intense and systematic international collaboration, training thousands of foreign police officials, making its computerized data bases available to foreign investigators and by initiating new endeavours in criminal legislation (Nadelmann 1993: 187).

9 See Stephen Vogel (1996: 36–37) for different strategies of the US in promoting regulatory reforms abroad and the FAZ of October 11, 1996: 33 for the view of German banks towards the SEC as vanguard of foreign regulatory change. David Vogel has characterized this process as the “California effect”: regulatory competition can

Table 3 Stock Market Indicators, 1994

	Number of Domestic Listed Firms	Market Value (in billions)	Market Value (as % of GDP)
Germany	666	773.9 DM	23.3%
UK	1803	1806.0 DM	111.7%
Japan ^a	2205	371024 ¥	79.1%
USA ^b	7525	5051.6 \$	75.0%

^a The figure for Japan represents the total number of firms listed on the Tokyo, Osaka and Nagoya exchanges. These figures circumvent the double-counting of firms listed on both exchanges.

^b The figures for the United States represent totals from the New York Stock Exchange, the American Stock Exchange and NASDAQ combined.

Source: Arbeitsgemeinschaft der deutschen Wertpapierbörsen, Tokyo Stock Exchange Fact Book, New York Stock Exchange, AMEX and NASDAQ

Germany was the definite laggard in this process and joined the bandwagon of modernization and re-regulation at the end of the 1980s. Nevertheless, the German case demonstrates very clearly the pressures faced by domestic actors when they become aware of the changing international landscape in finance. *German large universal banks*, traditionally more reliant on commercial lending than investment banking, realized that they had to catch up with international competition. Hence, at the international level, they stepped up their offensive in investment banking towards the end of 1989: all German banks acquired or established new investment banking houses in London, the most attractive financial marketplace in Europe. The Deutsche Bank, for instance, paid 950 million pounds sterling to acquire Morgan Grenfell, one of the most reputable investment banks in the world (Financial Times of May 29, 1996: VI).

At the domestic level, German banks engaged in the reorganization of their home market. By international standards, the German financial marketplace was seen as underdeveloped; market capitalization was only a tenth of that in the United States, although the US economy is only three times as large (Financial Times of May 29, 1996: I; see table 3).

Because market demand at home was so weak, banks attempted to attract foreign investors to the domestic stock market in order to catch up with competitors. But

promote a regulatory “race to the top” if the country which exports the high regulatory standard is of considerable size and has a large domestic market. The trading partners are then forced to meet those standards in order to maintain or to widen their own export markets. It is for this reason that both globally and within North America the California effect has occurred primarily through the influence of the United States (Vogel 1995: 6). See also Genschel/Plümper (1996) for the study of the different logics of “races to the top” and “races to the bottom.”

multinational customers like insurance companies, mutual funds or pension funds were now able to choose their trading places on the global scale and, in fact, they did not choose the German marketplace. Ironically, they did not even need to choose the German marketplace in order to invest in German shares – in 1990, the trading of the most liquid German shares at the London Stock Exchange accounted for about 13% of their turnover on the domestic market. Financial futures exchanges in London and Paris began offering DM-contracts, and “Deutschmark securities markets” grew outside Germany, with the centre of the Euro-DM-market being in London, followed by Luxembourg and Paris.

Different reasons for this lack of foreign investor interest in the German market have been cited: first, the costs of stock market transactions (i.e. turnover taxes, brokers’ commissions, costs for clearing and settling deals) were relatively high while product innovations offering risk-management opportunities were lacking in Germany. Second, and more important in its structural implications for the German system of sectoral governance, the German model of self-regulation came increasingly under pressure. Given the opaqueness of the self-regulated system, investors argued, one could trust neither the soundness of price-setting nor the willingness of self-regulatory monitors to sanction market malpractices. Moreover, when German banks invented new products and tried to sell them to foreign investors, they were blocked by regulatory bodies. Member firms of the German Options and Futures Exchange (Deutsche Terminbörse, DTB) were eager to sell their latest financial innovations (i.e. options on the index of the most liquid German stocks) to US-based finance houses and money managers. The US Securities and Exchange Commission, however, prohibited trading of these products in the United States by arguing that they came from a market which operated under lower regulatory standards than that of the US. Since the protection of domestic investors was seen to be the SEC’s primary mission, the agency pushed foreign market actors to guarantee US investors the same level of protection they enjoyed at home. The same happened when the German DTB together with the Frankfurt Exchange sought to set up computer terminals with their German electronic trading system “IBIS” on the trading floors of the London and Paris Stock Exchanges. Foreign investors would have been able to trade in German products on the German market by using the German trading system. Both exchanges denied this access by referring to the “lower regulatory standard” of the German market.

Although German banks still maintained that their model of self-regulation worked, they nonetheless were confronted with the reality that this model had become a major liability in the global competition for investors and that it was being used by foreign states to protect their markets against potential German competition. In order to participate in the global game, it became clearly necessary to prove one’s fairness and honesty as producers of financial services by op-

erating in a tightly regulated market under close state supervision. A high regulatory standard was now considered a “seal of quality” (Interview 950428) pushing the domestic market up in the global ranking scheme. All at once, German banks had an interest in “bringing the state back in” to their regulatory setting. This has become a significant goal, especially since 1990.

Up to this point, it is clear that it has been primarily *market forces*, stemming from structural changes in international securities markets that have driven the process of sectoral transformation in Germany. However, regulatory change would not have taken place without the involvement of the German state and, in fact, it was *political forces, growing out of the multi-layered system of interstate relations*, that pushed for a stronger role for the German state in sectoral regulation. The Federal Ministry of Finance had for a long time played a passive role in the process of sectoral restructuring simply because it upheld the model of self-regulation together with the banks more or less up to 1989. Nevertheless, the main problem the Federal Ministry faced, probably since the mid-1980s, was meeting the standards of interstate collaboration which evolved around issues of securities regulation. As I mentioned earlier, interstate collaboration on regulatory politics evolved both on the bilateral and at the multilateral level – Germany was able to carry out neither the first nor the latter task.

In terms of *bilateral* collaboration, a circle of bilateral exchanges had been developed up to the 1990s, from which Germany was excluded. In 1988, the SEC contacted Germany and applied for assistance in the prosecution of two cases of insider-dealing in which, apparently, German firms had been involved. Since Germany had no legal procedure for cross-border investigations of this kind, it was unable to meet the request for collaboration.

Similar collaboration failures also occurred at the *multilateral* level. As has been mentioned before, the EU Single Market Programme and particularly the directives on “Insider Trading” (1989) and on “Investment Services” (1993) considerably pushed the process of re-regulation towards a more investor-oriented model in securities regulation. Within the European Union, it was mostly Great Britain, the country with the second largest securities market in the world, that joined the bandwagon towards liberalization and reregulation of its stock exchange market, which had been set in motion by the United States in 1975. At the European level, Germany was in a minority position for different reasons: first, it had tried to block the passing of the legendary “Insider Directive.” This directive had finally brought the criminalization of insider trading and other forms of market malpractices. Member states were required to designate domestic bodies that would be responsible for the supervision and enforcement of insider-laws, disclosure rules and rules of conduct. The history of this directive dates back to 1976 when

DG 15 of the European Commission set up a task force of national stock exchange experts to sketch out a draft version. Since some of the member states, among them Germany, were quite reluctant to pursue this policy, only incremental progress was made. In May 1988, when the majority of other member states had either undertaken legislative action to ban insider trading or were prepared to do so, the German government, joined by the Federal Council and the financial associations, still rejected legislation in matters of insider trading (Bundestagsdrucksache 11/2358 of May 24, 1988). Consequently, in July 1989, Germany was isolated at the European level and faced the very likely scenario of being overruled when the directive was examined in the Council of Ministers. However, the key domestic actors were not willing to pay this price because they feared a further loss in the reputation of their national financial marketplace.

But even after these directives were passed, Germany was not prepared to implement them. As has been mentioned already, both directives required member states to determine domestic supervisory agencies for the securities sector who would be willing to collaborate closely with their foreign partners. However, the directives did not require these domestic agencies to be public bodies, but member states were asked to guarantee that these agencies could provide legal assistance and keep official secrets vis-à-vis third parties. Thus, the growing interstate collaboration in matters of monitoring and enforcement of securities law imposed indirect pressures on domestic partners to institutionally adjust their systems of sectoral governance to international standards.

Finally, additional pressures, deriving from Germany's membership in the International Organization of Securities Commissions (IOSCO) drove the Germans to adapt to the international regulatory standard. Since 1984, IOSCO has been the most important international organization representing national securities and exchange commissions. In contrast to the Basle Committee, its counterpart in international banking regulation, IOSCO is larger (115 members in 1994) and internally more formalized. There is a hierarchy in the governing committee structure and in the status of members. The core decision-making processes within this organization take place in the "Executive" and the "Technical Committee," both of which are composed only of members of the world's largest and most important securities markets. The range of possible kinds of membership covers regular, associated and affiliated members, partly ranked according to their public or private status. Private bodies such as stock exchanges could themselves be members of IOSCO, but as affiliate members they have not been allowed to vote and have been excluded from participation in the two central committees. Germany joined IOSCO in 1988, but was excluded from decision-making because it was represented by the Federation of the German Stock Exchanges. In 1990, the Federal Ministry was asked to take over membership of IOSCO, but lacked the technical

expertise for dealing with the details of securities' regulation. German representatives once more found themselves in a situation "where we were not able to collaborate" (Interview 950428).

5 The New Model of Sectoral Governance – Towards Further Centralization of the System

Faced either with an obvious loss of business or with a loss of political reputation, German economic and political actors launched a process of sectoral reorganization very much determined by the standards of foreign investors.

Given the fact that institutional investors are sensitive towards product innovations and towards the transaction costs of their dealing operations, German banks engaged in rationalizing market transactions and in integrating the organization of clearing and settlement facilities together with trading in the most liquid shares. In order to better control this process, the three big universal banks (Deutsche Bank, Dresdner Bank and Commerzbank) and the central bank of the savings banks sector, the Deutsche Girozentrale (DGZ) – all of which members of the board of the Frankfurt Exchange – pushed for a centralization of decision-making structures in the Federation of Stock Exchanges. Majority voting was to replace unanimity ruling and a new voting system would be constituted depending on each exchange's percentage share of the general stock market turnover. According to this new rule, Frankfurt and Düsseldorf together held 80 votes while the other 6 exchanges together only had 20. A new manager of the working group was appointed, who was at the same time a board member of the Frankfurt exchange as well as a representative of the Deutsche Bank. The Federation was renamed "Arbeitsgemeinschaft der deutschen Wertpapierbörsen" (Consortium of German Stock Exchanges) and given a new mandate for external lobbying while internally coordinating the introduction of product innovations and the restructuring of the common infrastructure (clearing and settlement systems, use of electronic trading systems; Müller 1986; Röller 1986).

Obviously, the former state of friendly coexistence between the different regional partners was no longer tolerated by the large banks, and within the circle a Frankfurt-based coalition crystallized, now using its market power in order to restructure the German financial marketplace according to its interests. Starting with the foundation of the German Futures and Options Exchange (Deutsche Terminbörse, DTB) in 1990, this coalition launched further steps towards sectoral centralization. The formation of this exchange not only meant the introduction of

product innovations in Germany since it reintroduced derivatives trading, but it was the first fully computerized national exchange in Germany and therefore broke with the regional principle of stock exchange organization. In order to raise capital for the process of restructuring, the large banks founded the Deutsche Börse AG, a common joint-stock company in 1991. The firm should act as an umbrella organization for all German exchanges and in particular centralize the clearing and settlement facilities needed by the other exchanges. Struggles between the Frankfurt coalition and the regionally oriented actors preceded the formation of the new organization since Frankfurt first proposed that not the regional exchanges but their member firms should become shareholders of the new joint company (Deutsche Sparkassenzeitung of June 11, 1991: 1). However, the votes of the regional partners were needed for the planned reorganization and that is why Frankfurt offered the seven regional exchanges a 10% ownership share (Deutsche Sparkassenzeitung of November 11, 1991: 3). This was definitely not a great deal for them, but, together with regional banks and brokers who held a further 22% of the firm's capital, they hoped at least to form a strong minority among the shareholders able to veto decision-making procedures (Interview 950323).

Hence, resistance against Frankfurt would have required considerable collective action among the regional actors, and the further history of the German stock market development revealed that this capacity was increasingly declining. In the meantime, the Frankfurt coalition has not only become stronger but also broader, and includes today Düsseldorf and Munich as the next larger exchanges as well as Berlin, the exchange of the German capital. From the viewpoint of Frankfurt, these partners represent the dedicated survivors of its new project of replacing floor trading by electronic trading by the end of this century. This project is part of the Deutsche Börse's new strategic scenario, announced in May 1995 as the "ZEUS concept," to reorganize itself into a finance company, offering a broad range of services around the equities business (see for example Handelsblatt of May 31, 1995: 1). Of crucial importance for the future of the smaller exchanges was that the four partners decided to share a common order book, in which trading of the most attractive 100 DAX-shares was divided between the four of them, with Frankfurt getting the first 30 equities. Regarding those equities which are not part of the first 100, but nevertheless traded at more than one exchange, issuers and related banks were to be persuaded to trade these papers only at one of these four exchanges (Handelsblatt of November 27, 1995: 1).

It is obvious that the *smaller, regionally oriented actors* are the likely losers in this distributional conflict. Smaller exchanges cannot completely rely on their regional niches but need to trade some of the attractive shares in order to survive. Furthermore, strong coalition partners, able to resist the pressures towards centralization, are lacking. The future of brokers is unclear, too, since electronic trading

would more or less displace stockbrokers and their official function of price-fixing. Only capitalized brokers will be able to survive and will need to reorganize into American style investment houses.¹⁰ The German Länder governments (except Hessen) are eager to express their political will to preserve a federal stock exchange market (Handelsblatt of March 13, 1996: 37). They fear losing regional and also larger businesses who presently hold up their regional exchanges. Smaller investors and issuers would lose access to an important source of capital since they would find it too expensive to access the centralized Frankfurt Exchange (Coleman 1996: 141). Nevertheless the Länder are unwilling to intervene and have declared the future of the regional structure to be a “question only the market itself will decide.” Given the power differentials on this market, further monopolization of trading will be the likely outcome of this decision.

In sum, the centralization of the market structure clearly revealed that the large banks, those actors who had hitherto supported the regional cartel system, lost their incentives for upholding it. The costs and gains of share dealing were no longer defined on the home market, but on the global one. Thus, from the viewpoint of global players, arrangements seeking to distribute costs and gains among the circle of domestic market players were becoming obsolete, particularly if they imposed the costs of collaboration on the actors that had become the object of global competition: the investors. The global guideline for restructuring of markets was to minimize transaction costs of equity dealing, a strategy which no longer left room for “interorganizational slack,” that is for subsidizing weaker partners at home. Therefore, increasing heterogeneity of interests among the group of market players slowly eroded former preconditions of collective action.

Meeting standards of international competitiveness, however, required more than simple market restructuring. From the viewpoint of the major German banks, the *regulatory framework of stock market trading* had also turned into a critical factor determining the international ranking of the domestic financial marketplace. This was exactly the point where market actors had to rely on the state and worked on “bringing it in” to the system of sectoral supervision. Additional pressures on the Federal Ministry of Finance came from the *supranational* level since the approval of the EU-directives on “Insider Trading” and “Investment Services” required participation in the establishment of a collaborative network of domestic regulatory bodies. In January 1992, Finance Minister Waigel presented a pol-

10 Frankfurt's Chamber of Stockbrokers was recently reorganized into a joint-stock company. From the viewpoint of its members this should allow it to better influence the policy of the Deutsche Börse and to “have a stronger voice” in disputes about the reorganization of the Finanzplatz Deutschland (“German financial market place,” FAZ of January 25, 1996: 20).

icy paper in which further support for the “Finanzplatz Deutschland” concept was announced (Der Bundesminister der Finanzen 1992). The paper noted the need for a new market supervisory body located at the federal level and for further regulations protecting against insider trading and providing equal treatment of shareholders. Furthermore, the Ministry declared its willingness to moderate the forthcoming decision-making procedures. This paper was basically the outcome of consultation with members of the Commission of Experts for Stock Exchange Matters (*Börsensachverständigenkommission*), an advisory body of the Ministry, representing banks, banking associations, politicians and related academics. These actors formed the core of a *new coalition of “globally oriented” players* that placed the need to meet international standards of regulation at the centre of the debate. They were joined by the state government of Hessen, which from the beginning of the “Finanzplatz Deutschland” discussion had promoted the position of the Frankfurt-centred banks and voted for a federal solution to the supervisory problem, modelled on the United States Securities and Exchange Commission. Similar to the collapse of the economic cartel, the formerly stable political cartel of the German states and market actors, united in defending their sphere of competence against federal intervention, eroded as well.

Nevertheless, the German system of federalism allows the German states to veto decision-making processes in matters listed under Art. 74 of the German Basic Law. Indeed, it was their codecision rights in stock exchange Legislation that permitted them to decide on the passing of the new law, known as the “2. Finanzmarktförderungsgesetz” (Second Financial Market Promotion Law). This was their most powerful resource in the forthcoming negotiations. In fact, the creation of new regulatory competences for the federal level provoked a new confrontation as the *Länder* feared the loss of their own historical jurisdiction in the area. The *Länder* proposed the setting-up of a common supervisory agency. Not surprisingly, this proposal was met with resistance from the global coalition, which feared that an agency carried by a “conglomerate of German states” would lack clear international visibility and would not meet the requirements of interstate collaboration. Structural changes in the international market environment supported the position of the global players. At the same time, a compromise was needed since the states could use their codecision rights in matters of stock exchange legislation to veto upcoming federal legislation aimed at creating a federal supervisory body. In January 1992, a common working group of federal and *Länder* representatives was constituted (*Bund-Länder-Arbeitskreis*) in order to draft a compromise. Turf battles lasted for almost a full year, and finally it was the Federal Ministry which came out the winner in this conflict.

A new regulatory model was decided upon, the crux of which was a supervisory agency for securities trading under the jurisdiction of the *Bundesaufsichtsamt für den Wertpapierhandel* (Federal Ministry of Finance). Its tasks involve the surveil-

lance of large share transactions and rules of conduct in securities trading. Moreover, the agency enforces a strict regime controlling insider trading and, in particular, represents Germany in international circles of securities regulation. Although the German Länder did not achieve their original objective, they retained some regulatory responsibilities. Their supervision of their respective securities exchanges was expanded, a new *Wertpapierrat* (Securities Council) was founded, which was almost identical with the existing working group of states and intended to provide advice, but not participate, in decision-making. The stock exchanges themselves lost power since formerly self-regulated matters became the subject of federal supervision or were regulated in public law. Nevertheless, the exchanges were asked to set up a new body for supervising stock exchange trading (*Handelsüberwachungsstelle*) whose task was to collect data electronically on market transactions and collaborate closely with the Federal agency. In general, a complex regulatory structure evolved which reflects the kind of "interlocking politics" characteristic of the German model of federalism (Scharpf et al. 1976). So far, it is not completely clear where the responsibilities of the three levels of regulation end or whether they overlap. Regulatory practice has shown that direct contacts between the federal level and the stock exchange level prevail while, at least in some German Länder, regulatory supervision is more of a symbolic character. And given the likely scenario that share dealing will be concentrated at four places or even monopolized in Frankfurt, there is little reason for preserving the regulatory duties of all the states.

Seen as a whole, a new regulatory model of stock exchange regulation has been set up, in which the regulation of market malpractices under the supervision of the federal government plays a distinct role. Obviously, actors have shifted regulation towards a more *investor-oriented model*, stressing customers' rights of information and transparency where market transactions are concerned. Professional norms and informal rules are increasingly substituted by rules that are embedded in public law. Although this model imposed additional costs on the producers, they have had no other choice finally but to join the international bandwagon and push for it as well. High standards of investor protection have turned into a matter of international competitiveness since the quality of products is now measured according to the regulatory framework in which "production" is embedded. Public participation in the system of sectoral supervision has become a critical factor that allows access to new foreign markets. Shortly after the new supervisory body began its work in January 1995, for instance, members of the German Options and Futures Exchange were allowed to promote and to sell their latest financial innovation (= Future Contract on the DAX) to US-based firms (FT of January 1, 1995, 15). In March 1996, Germany was permitted to set up computer terminals with the German electronic trading system in the United States (Handelsblatt of March 3, 1996: 33).

The German federal government, on the other hand, did not participate actively in the first stages of sectoral reorganization. But once it faced a threatening loss of reputation and of influence over the policies of securities regulation at the international level, it decided to take the initiative and push for a larger role of the federal state in the regulatory setting. In fact, political actors were even “rewarded” for adjusting institutionally to global standards: in January 1995, the recently established German supervisory body took up membership of IOSCO, and a couple of weeks later, Germany assumed the vice-chair of the Technical Committee. In addition, several cooperative agreements were signed between the German supervisory office and foreign regulatory counterparts, the first among them being those with the US Securities and Exchange Commission, and the Commodities Futures Trading Commission of the US.

6 The Revival of the Nation-State?

Financial internationalization, driven by structural market changes and accompanied by increasing interstate collaboration in matters of securities regulation, has in fact provoked structural shifts in the architecture of domestic governance systems. Apparently, the nation-state has gained new competences in the model of sectoral supervision, which derive from two sources: from the *inability of market actors to regulate themselves* and from the *strength of the international system of states* that imposes new duties on its members.

First of all, it has become obvious that traditional and historically evolved systems of self-regulation by market actors suffered from *internal* erosion due to new competitive pressures. The former cartel-like arrangement between market actors that had provided room for subsidizing the weaker partners of the circle relied on the fact that its costs could be shifted to the customer, that is the investor, side. Under conditions of increasingly internationalized markets, however, this condition was no longer given since investors had become the most attractive object of international competition. Thus, the larger banks which had hitherto upheld the former cartel lost the incentive to support it. From their perspective as self-defined global players, domestic cartels were now seen as a major liability in international competition and had to be replaced by a market structure which offered investors the lowest possible costs of market transactions. Weaker partners, among them smaller exchanges, stockbrokers and regionally oriented banks, are the likely losers of a strategy of sectoral reorganization that centralizes stock market trading according to global standards.

Probably more important than the internal pressures of erosion, however, are the *external* forces that undermined the former domestic model of sectoral self-regulation. Even if cartel-like relations had continued to exist, it is questionable whether the old regulatory model could have survived. The reason for this is simply that self-regulation had lost legitimacy as a governance mechanism at the global level, mainly because structural changes in international securities markets went hand-in-hand with changing power relations between the producers of financial services and the investors of financial assets. Securitization and the rise of institutional investors made it likely that those who profited most from higher regulatory standards would be able to push for an investor-oriented regime of protection. A regulatory model based on “tacit rules” and trust-like relations among producers was not tolerated by foreign institutional investors, who were neither part of it nor able to understand its rules. Conversely, non-transparency raised suspicions of collusion and the misbehaviour of financial intermediaries. In the view of investors, self-regulation was obviously no longer an appropriate governance mechanism that could prove the fairness and honesty of financial producers in particular, and the safety and soundness of market transactions in general. Moreover, a system of increasingly integrated domestic securities markets, governed by different models of self-imposed rules, would have incumbered investors with considerable “learning” costs: as multinationals operating more or less decoupled from territory, time and personal relationships with financial intermediaries, customers were unwilling to familiarize themselves with all the different types of self-created systems of investor protection. Thus, for reasons partly to do with the credibility of market regulation and with lowering the costs of market transactions, market actors were interested in harmonizing the rules of the market game and in delegating supervision of them to the state, whose legitimacy as monopolist of violence has not yet been questioned.¹¹

The second source of increased competences of the nation-state was, quite ironically, the increasing *interdependence with its foreign counterparts* and, in particular, the growing network of interstate collaboration. However, it is important to note first that the nation-state has in fact lost autonomy in the *formulation* of regulatory policies towards its market constituencies. We have seen very clearly that states are increasingly engaging in processes of “regulatory competition,” i.e. for the most attractive and mobile investors. The type and level of market regulation,

¹¹ One could therefore argue that new supervisory powers for the state were nothing but “capture” (Stigler) of it by the global market players. However, German banks were also willing to engage in costly and time-consuming duties to report their share transactions to the newly founded agency and carry 90% of the operation costs of the supervisory body – expenses only incurred for the sake of international competitiveness.

therefore, turns into a crucial asset that more than ever determines the ranking of the domestic territory in the system of increasingly integrated securities markets. Since its policies are measured according to their contribution to international competitiveness, the state is no longer sovereign in the choice of its policies. The market itself defines the quality of public policies. Moreover, the case has demonstrated very clearly that regulatory policies are formulated and negotiated in systems of bilateral and multilateral collaboration, both of governments and of specialized public regulatory agencies. Nation-states are in fact mere “negotiation partners” in the international arena, and are therefore forced to engage in compromises and to often accept second-best solutions.

However, international regimes have their limits as well, and the case has shown that the *monitoring* and *enforcement* of negotiated rules is a task that both the European Union and specialized regulatory regimes like the Basle Committee prefer to delegate back to their member states. It is exactly the newly delegated function of market supervision that the state’s new task is all about. Nevertheless, reciprocal exchanges, i.e. of information or of legal assistance within the international circle of regulatory bodies, impose certain demands on the members of the exchange. Information on market constituencies can be gathered and exchanged much easier if the exchange partner is a public agency, enjoying at least formally more autonomy from the objects of supervision than a private association for instance. Moreover, “legal assistance” in cases of, say, cross-border fraud implies that the exchange partners can rely on legal procedures for the prosecution of insider-dealing and therefore make use of resources only states possess. In other words: equality within international networks of securities regulation presupposes similar competences on the part of the collaboration partners at home.

New tasks of market supervision have obviously also shifted the *internal* balance of power, i.e. power among different levels of the nation-state as well. In general, we can observe that the federal state gains power vis-à-vis the state level because it serves as a pivot for the international community of financial market regulators, where regulatory frameworks are harmonized and the international playing field is negotiated (see also Hirst/Thompson 1996 for the notion of nation-states as components of an international “polity”). In addition to this “disequilibrium” of the former stable model of power sharing within the federalist system (see Deeg/Lütz 1996 for the implication of financial internationalization on federalist states), a second dimension of this power shift has crystallized as well. Increased competences on the part of the federal government have come with the establishment of specialized agencies within the executive branch of the state. These supervisory bodies, either operating under the jurisdiction of the federal state as in Germany or via independent regulatory agencies in the style of the US, are at the core of the new state functions and, as Majone has argued in the EU context,

they indicate the changing nature of state-society relations (Majone 1993: 30). In order to fulfil credibly the task of market supervision, they require a certain autonomy both from parliament and from the central administration. Since they are staffed with trained professionals, in the German case both from the market and the administrative side, a technocratic view on regulatory politics is very likely. Traditional channels of legitimized political power are apparently losing importance while specialized parts of the political administration are extending their autonomy, i.e. by engaging in worldwide coalition-building with their foreign counterparts. The state is no longer a unitary actor, but its parts most in touch with the global economy are increasingly leading “a life of their own.”

Taken together, how can we qualify the relationship of states and markets against the background of pervasive blurring of territorial boundaries? Internationalization has redefined the role of the nation-state as manager of the national economy. That the chances of Keynesian fine-tuning of economic policies have been considerably reduced by highly mobile capital does not mean a return to a pure market economy. Even securities markets, seen as the most fluid and mobile segments of financial capital, have to be organized. Property rights have to be guaranteed and rules have to be set and monitored – tasks which obviously cannot be fulfilled by market participants themselves (Boyer 1996: 110). It is most apparent that the widening of market boundaries requires a set of agreed or imposed rules of the game, there is no spontaneous implementation of market mechanisms (see also Underhill 1991 for the importance of “politics” for the expansion of financial markets). The state is therefore back again by ensuring transparency, fairness and access of markets through legal penalties for non-compliance (Boyer/Drache 1996: 3). States and markets are increasingly dependent on each other because the discipline of the market and the rule of money is enforced by the rule of law. In this sense, the new state functions resemble very much the functions provided by the liberal state of the mid-19th century (Panitch 1996: 95). As “competition state” (Cerny 1993) the state of the late 20th century allies *de facto* with those political and market actors that profit most from the territorial expansion of markets, thereby forming new coalitions of globally oriented players at different political levels, while the potential losers are obviously left behind. The nation-state is brought back in to support and not to withstand the worldwide integration of capital markets.

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