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Book Review

The Political Economy of Financial Market Regulation

Edited by Peter Mooslechner, Helene Schuberth, and Beat Weber. 2006. Cheltenham: Edward Elgar. 255 p. ISBN-13: 978-1-84542-518-0, £65

The current financial crisis as reflected in the banking crisis has now brought to the fore the issue of the regulation of the financial sector. Although published in 2006, the book raises a pertinent issue which has become so topical that it calls for a review of the book, especially that the issue has been addressed from the political economy perspective. The crisis has now forced industrialized countries including the U.S.A. to look into the regulatory environment surrounding the financial sector after leaving the sector for a considerable period of time mostly to self-regulation. The regime of self regulation has been largely driven by a culture of laissez faire.

Financial crises can manifest in three different ways, namely, banking, currency and sovereign debt crisis. Symptoms of the current banking crisis appeared in early 2007 becoming full blown crisis in the second half of 2008 affecting all parts of the financial sector. The crisis has become a front page issue around the world possibly prompting a plethora of books and essays suggesting explanations and possible solutions; some new others recycled.

The book contains three articles embracing the theoretical issues relating to financial governance to provide an overarching framework to analyse how the interplay of conflicting interest groups lead to inclusion and exclusion and six case studies dealing with the main theme of the book. The book points out that political power shapes economic outcomes and economic power leads to political power. Therefore political exclusion leads to economic exclusion. Exclusion is defined as not being able to participate in overall welfare of society or the severe restriction of the ability to participate. Generally exclusion from decision making is legitimized because finance is considered an exclusive domain of experts.

Underhill provides a survey of the main economic and political economy theories pertaining to governance, which is helpful for the uninitiated. He questions the validity of state-market dichotomy and argues that state and market constitute an integrated system of governance which he calls state-market condominium. He sees state as a forum to settle conflicts taking place in the market and international cooperation seeks to extend this to areas where direct state authority is uncertain. He goes on to provide an analytical overview of the current global financial architecture with a special reference to Basel II capital accord. The accord creates an international standard relating to capital that banks are required to set aside to guard against financial and operational risks. He calls for reform of the global financial system to facilitate access to the policy process for interests that are currently excluded, especially developing countries. He points out that the current piecemeal reform process with its emphasis on facilitating market efficiency is likely to prove deeply flawed, as the events in the recent past have demonstrated. His model envisions a financial governance that is more inclusive and compatible with the market system. The underlying argument is that a more inclusive international financial governance will provide a more stable global financial system. This approach has its merits but the reality is messy and full of uncertainty. The short-term nature of financial flows with high turnovers and the complexity of financial instruments involved in (often non transparent) transactions make it an extremely complex process. The post Bretton-Woods financial system had generated its own political and economic logic which remains deeply entrenched in the psyche of policy planners. Underhill tells us that a condominium of state and market agencies dominates the financial monetary governance process in a self-interested way. As to why it is so, the article is vague on details.

Lutz comes very close to the reality that we face now. She argues that power relationships between government and market actors are key variables in understanding how a regulatory regime is put in place. This clearly recognizes power asymmetries in society, which helps us to understand the process of inclusion and exclusion. To understand these relationships, three competing models of the state-market nexus are presented. Regulatory changes in the field of finance can be triggered by competition among states, which is reflected in the changing global financial environment. In responding to such changes, state and market actors join together to forge modernization coalitions to promote financial reform. Those who benefited mostly from open and globally integrated financial markets obviously formed the core of these coalitions. This is clearly demonstrated when the state came to the rescue of these players as the tide turned against them. Therefore, Lutz suggests a coalition of market actors and state has brought about the changes. However, it appears that the coalition has been replaced by market actors being completely able to capture the state. Posner (1974) gives an insight into how a regulatory regime put in place by government to achieve well-intentioned objectives can be captured by the regulated industry. Olson (1965) also argues that smaller organized groups (i.e. industry groups) have an advantage over large and diffused groups (i.e. consumers) in defending their interests. Similarly, Becker (1983) argues that the relative strength of the pressure groups ultimately decides the policy outcome.

In the last article, Unger provides a reasonable coverage of literature on financial governance. The article is helpful in understanding the extent of the state's ability to act. In the context of contemporary financial deregulation and reforms, the state fits closely to the model of a corporate-bargaining state, which has a stable, institutionalized political process but with a reduced role for legislators and the public, delegating authority to others where bureaucrats and special interest groups play the dominant role. This she describes as technical determinism. Therefore the idea of a sovereign state is absent in global financial governance. Given that finance remains an esoteric topic, therefore it does not elicit wide public debate. The finance industry can also organise itself much better than consumers and workers at the national and international levels and has been successful in promoting neo-liberal ideas into popular dogma. The article, Unger agrees, can not provide an answer to the question "Who governs"? The article attempts to put the issue on the research agenda and provides some coverage of literature and some theoretical approach that might enable researchers to provide some answers to the issue. Unger, in line with Lutz, suggests that finance can exert powerful economic pressures on the state to institute policies most suitable to its interests. This is exemplified by recent government responses to financial crises in advanced industrialised countries with massive government bail out packages.

The three articles in the book have a common theme: that the powerful finance industry has the ability to influence the state machinery to institute a regulatory regime which helps to advance the interest of the industry. This is also reflected in the way the multilateral system that governs the global financial system works. During the 1997 Asian financial crisis, the International Monetary Fund (IMF) stepped in to "bail-out" Thailand, Indonesia and the Philippines with very harsh economic measures allowing banks and companies to failin effect telling the governments to "let the markets decide". These off –the- shelf textbook-based economic policy measures (known as the Washington Consensus) led to near economic collapse of these economies resulting in mass unemployment and exacerbating poverty. Such policy measures were strongly supported by all leading industrialized countries at the time. Now the wheel has turned a full widethe developed economies, facing their most serious financial crisis since the Great Depression, have adopted exactly the opposite measures. Governments in these countries are coming in a big way to provide financial support to resuscitate the failing banking and insurance industries. The U.S government has become the leading mortgage lender, the effective owner of the world's largest insurance company, bailing out banks and pump priming the economy. They have ignored the medicine they prescribed to the ailing Asian economies in 1997. The hypocrisy is stunning to say the least. I am sure this has not gone unnoticed in Asian countries including Thailand. Underhill quotes Paul Volker (former Federal Reserve Chairman from 1979-1987) to highlight the power asymmetry among countries. Volker stated that when IMF conditionality confronts a poor indebted country, the country gets into line but when IMF conditionality confronts a wealthy member of the IMF board (debtor or not), the Fund gets into line. Not surprisingly, the only major missing element in this round of financial crisis experienced by the leading industrialised countries including the U.S.A. is the strident voice of the IMF denouncing bank nationalisations.

The six case studies delve into a wide range of issues. They include the role of private sector associations in global finance, financial market integration in the EU, financial literacy programs for the poor, the governance of Over the Counter (OTC) derivatives markets, Basel II, and the regulation of pension funds.

Porter examines how private sector actors are organised in global financial markets and their influence relative to state in the functioning of these markets. To explain who is in and who is out he provides two interrelated themes that are critical of the global finance. First, he points out that the financial elite deliberately exercises control over states and markets, second, he argues that there are structural factors that promote the dominance of finance over other aspects of contemporary life e.g. threat of capital flight to force a government to toe the line. Left on their devices, associations representing the private interests will only work to enhance their own self interests at the expense of others with consequent negative impact on the functioning and legitimacy of global finance. Porter then suggests further research to identify measures that will ensure that associations representing private actors behave in a way that will strike an optimal balance between competing interests, which may include public policy and regulatory initiatives.

Weber covers the European Union's (EU) recent policieson financial integration, which has gained momentum since the turn of the millennium. The introduction of the euro in 1999 provided further impetus for the integration of financial markets and competition between financial centres. While the Financial Services Action Plan envisaged a thorough overhaul of the European financial architecture, in reality decision making process is dominated by a small circle of experts from member countries' administrations and financial service providers.

Schurz provides a critical overview of efforts to increase financial literacy of the poor in the United States. This is seen as an instrument to deal with financial exclusion of the poor. He argues that such initiatives are unlikely to yield any satisfactory result because these do not change the power dynamics to alter income distribution. Indeed such initiatives reinforce hegemonic values of the society thereby legitimising financial exclusion.

Tsingou deals with OTC derivatives. Derivatives are used to transfer risks involved in international borrowing and trade transactions. The derivatives markets have grown rapidly over the last 20 years. While derivatives are traded on exchanges, about 40% are traded over the counter, where no formal regulation of the industry exists. It is mostly a self-regulated industry because it is the considered opinion of international public and private actors that that is the most efficient form of governance for this industry. The author thinks otherwise and argues that the international policy community has in effect devolved significant regulatory and supervisory functions to private actors.

Redak deals with Basel II, one of the well known recent regulatory reforms relating to financial governance. Basel II is a set of recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision in 2004. She focuses on the relationships between public and private agents and sees Basel II as a mixed picture. Private agents such as rating agencies will have much greater authority and in some respect supervisory authorities will have increased discretion. Under Basel II private industry interests have become more important as its concerns are internalised while other important interest groups such as labour and consumers are absent from the process. In this context it is pertinent to refer to Stiglitz (2008) when he argues that multiple conflicts of interest in our finance industry have led to the rewarding of socially destructive behaviour. The worst culprits have been the rating agencies, which are paid by the companies whose financial products they were supposed to evaluate, and make money by advising their clients on how to get AAA designation.

Schmitz, through a case study in Austria, examines issues surrounding private pension funds, which have been growing in importance in recent years in the provision of social security. He concludes that neither internal governance system nor market competition provides an incentive structure that effectively addresses the structural dominance of shareholders' interests at the expense of beneficiaries. In a conflict of interest concerning governance structure, shareholders' interests prevail. Schmitz like other contributors to the book agrees that asymmetries of power at the political level have substantial repercussion on the governance structure at the micro and macro levels.

All six case studies support the main argument enunciated in the three articles that exclusion and inclusions are a consequence of political process where money not only talks but also acts to safeguard its interests.

The book gives a reasonably good perspective to understand how regulatory regimes at national or global levels operate from a political economy perspective. It definitely provides theoretical and some empirical evidence to support the main arguments laid out in the book. It gives a good analysis of issues surrounding governance theories pertaining to finance.

At the broadest level, the book has brought to a point of articulation, but not to a point of resolution or synthesis, the issues surrounding the regulation of financial markets. The book carries on the long standing discourse in regulatory economics.

This round of financial crisis has reached the heart of the global financial system. Its ramifications are still unfolding and responses to deal with it vary from country to country depending on the severity of its impact felt on the individual country and the level of political will. The recent G20 Summit held in Washington was an attempt to bring about a coordinated approach to deal with the crisis. The severity of the crisis has led to a suggestion floated by the G2O to consider the establishment of a World Financial Organisation along the line of the WTO to regulate the global financial markets. The U.S.A is opposed to such an institution. That being shelved, the G20 countries have agreed to work together to restore global growth and achieve reforms in the world's financial systems. The close congruence between different types of financial markets has made it impossible to confine risks to one type of market. Therefore there is an obvious need to reconfigure the financial regulatory structures. Once again we may have to look at the political economy process to make some sense of whatever new financial regulatory structures may emerge as a result of the Washington Summit of G20 countries. This will enable us to understand how effective these structures could be. In this context the book remains an important reading.

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