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Stock exchange regulation in an era of globalized financial markets
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PLEASE SCROLL DOWN FOR ARTICLE
The revival of the nation-state?
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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 seem to profit from economic and political deterritorialization. They may use their wider choice of geographic location in order to lobby for low regulated market environments. The article seeks to differentiate this common view considerably. It argues that economic internationalization tends to erode the legitimacy of self-binding agreements that had formerly 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 German stock exchange sector that underwent a process of fundamental transformation leading to an enhanced role of the nation-state in the model of sectoral governance.

KEY WORDS European Union; financial markets; globalization; governance; multi-level decision-making; regulation.

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 (Strange 1996; Cable 1995; Schmidt 1995). States experience both external and internal challenges to their autonomy. Since they delegate policy-making powers to the supranational level of the European Union or even global arenas, they are less autonomous in the formulation and implementation of policies for their constituencies. 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.

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 and engage in regulatory ‘races to the bottom’ in order to attract the most mobile segments of capital.

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, world-wide integration of financial, particularly securities, markets has been taking place since the mid-1970s. Economic integration has been partly facilitated, 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 politics, while internally they are ‘hollowed out’ (Jessop 1994) by more mobile and internationally based financial capital, which is playing them off against each other.

The argument to be developed in this article will not completely contradict this scenario. However, it will differentiate it considerably, in particular with respect to the unconditional assumption that financial firms have been strengthened and the state has been weakened by internationalization. First, the article argues that the nation-state has not lost its importance in this era of globalization: new state functions have even been ‘brought back in’ (Evans et al. 1985) to a model of sectoral governance that had formerly been characterized by a stable pattern of private self-regulation. By monitoring and enforcing the new rules of the global game, the state becomes the ‘upholder of the law’. Second, the sources of new state functions and the mechanisms behind this process of institutional transformation are explored. It is shown that structural changes in international financial markets and the growing importance of interstate collaboration in regulatory matters have shaped the strategies of German banks and the German government. While market actors became aware that the German model of sectoral self-regulation had lost legitimacy under conditions of financial globalization, government officials faced the need to meet international standards of collaboration. Thus, both financial firms and the state changed their preferences in favour of institutional change in order to make the domestic system of sectoral governance compatible with the international political economy.

The article 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 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.
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, the latter, more rationalized view of stock exchanges dominates the scene. It is precisely because of 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 electronic equity trading via private firm networks. Somewhat ironically, a type of private self-regulation has characterized the 'icons' of capitalism for a long time. The New York Stock Exchange (NYSE) and the London Stock Exchange (LSE) operated as exclusive clubs of stockbrokers or investment houses, banding together by price-fixing for services rendered to non-members (for an overview, see Sobel 1994; Moran 1991, 1994; Coleman 1994, 1996).

In Germany, 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. Internally, the exchanges were governed by a number of self-regulating committees which dealt with, for example, admission to security listings, fees for equity trading or 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. In 1896, the German provincial states took over legal supervision of their respective stock exchanges and appointed 'State Commissioners' to oversee the implementation of federal and state law. However, the states 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 (Länder) were granted co-decision 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, played only 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 the regulation of behaviour.

Sectoral self-regulation, tolerated by the federal government, was accompanied, if not made possible, by cartel-like relations between stock market actors. First, cartel-like relationships evolved out of the dominant role that 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. 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 relationship between house banks and industry. From this it followed that capital markets were underdeveloped and the banks themselves held the majority of industrial shares in domestic stock markets. Restricted competition for industrial clients, therefore, was simply the outcome of the banks’ structurally based position of power in the German financial sector.

Second, cartel-like relationships also characterized inter-exchange relations. In Germany, competition between exchanges was restricted through the system of German federalism. There were eight regional exchanges in Germany, with half of them generally trading specialized shares of a regional character (Bremen, Hamburg, Berlin, Hannover) and only the larger exchanges (Frankfurt, Düsseldorf, München, Stuttgart) competing for the most liquid and therefore most attractive ‘blue chips’. Despite obvious power differentials – Frankfurt alone covered almost 75 per cent of all stock market trading in 1990 – a stable pattern of collaboration governed inter-exchange relationships. 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. As long as equity dealing played only a minor role in German finance and 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. Since a strong lobby of institutional investors (as existed in the United States) was lacking in the domestic market, no one complained about this.

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 united by the common interest in defending their sphere of influence against intervention by the federal state. For market actors, in particular for German banks, the model of sectoral self-regulation was a very comfortable one because 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, 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 choice other than to trust in the functioning of self-regulation. The cartel of sectoral governance was based on two preconditions: on the relative unimportance of the investor in the stock market, and on the fact that the big German universal banks, as the market's dominant actors, supported it. We shall see that at the end of the 1980s these preconditions no longer existed.

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 Organization for Economic Co-operation and Development (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 world-wide scale and by the deregulatory activities of national governments. Domestic governments allowed financial innovations to be traded, lowered access barriers to stock exchange membership for foreigners and replaced former price cartels by systems of negotiable commissions for brokers and traders (for an overview, see Cerny 1993; Laurence 1996). By the early 1980s, cross-border flows of capital had reached enormous volumes and issuance and trading of securities on international markets burgeoned.

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 pressures by institutional investors. Borrowers, especially those who are credit-worthy, prefer to transform their liabilities into tradeable securities since this is a much cheaper way of raising capital than relying on bank credits (= securitization). Institutional investors, on the other hand, have become the major players on globalized securities markets. During the last fifteen 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 investors in securities and other financial assets. The power of institutional investors is based on the fact that they are operating with large blocks of the most liquid shares; as multinationals they may choose from among the most innovative and price-sensitive trading places in the world (Gerke 1995).
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 cross-border contacts between domestic regulatory bodies aimed at monitoring and enforcing rules. Interstate co-operation is practised at the bilateral as well as the multilateral level. Bilateral Memoranda of Understanding (MOUs) between domestic regulatory agencies have, until recently, been the predominant form of regulatory co-ordination 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 co-ordination on matters of securities regulation took place at the level of the European Union whose Single Market Programme of 1985 hastened the integration of European capital markets considerably. In particular, the directives on insider trading (89/592/EEC of 13 November 1989) and investment services (93/22/EEC of 10 May 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 (see also Kapstein 1994). That is, they required member states to specify a supervisory body for the securities sector which would then co-operate closely with its foreign counterparts. Further co-ordination takes place in the International Organization of Securities Commissions (IOSCO), an international regime of national regulatory bodies (for IOSCO, see Coleman and Underhill 1995). During the 1980s, IOSCO was transformed more and more into a global platform for co-ordinating 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 world-wide process of domestic financial marketplace restructuring was set in motion. Reorganization was partly aimed at modernizing the infrastructure of stock exchange trading; but it was the regulatory framework of stock markets in particular that underwent a 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 (on the general point of freer markets and tighter rules, see S. Vogel 1996). In a large number of industrialized countries systems of stock exchange governance underwent a process of ‘institutionalization, codification and formalization’ of rules (Moran 1991) together with a strengthened role of the state. Either regulatory tasks were delegated 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. Hegemony refers here to the coupling of market power and political power in the international arena. 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. Starting at the
beginning of the 1970s, these institutions used their position of structural power to foster the erosion of price cartels of domestic investment firms and to place issues of investor protection at the centre of the regulatory debate (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 the most attractive customers, their wishes drive the strategies of foreign producers and regulators.

The political power of the United States 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 rests not only on the fact that it is the oldest regulatory agency in the securities sector, but also on the fact that the agency upholds a regulatory model seen as the most investor-oriented 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 globalized 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 by using the instrument of bilateral MOUs. 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 conducting investigations at the request of foreign agencies or getting documentary evidence from abroad. For instance, if a foreign financial firm has violated a domestic securities law, the domestic regulatory body can ask its foreign counterpart for legal assistance. 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. Private associations could have great difficulty in lifting the domestic bank secrecy veil. Moreover, a banking association with self-regulatory powers, for example, appears to be a less trustworthy partner in exchanges of business secrets since these could be leaked to the association’s members. Thus, signing an 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 SEC had signed twenty MOUs world-wide by 1994. In almost all these countries, MOUs with the SEC either preceded the establishment of new public regulatory agencies or followed shortly afterwards (for MOUs in general, see Smith 1988; Baumgardner 1990).

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

Germany was the definite laggard in this process and joined the bandwagon of modernization and re-regulation at the end of the 1980s. Large German 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, all German banks acquired or established new investment
banking houses in London, the most attractive financial marketplace in Europe. 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. 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 multinational investors were now able to choose their trading places on the global scale and, in fact, they did not even 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 per cent of their turnover on the domestic market. Financial futures exchanges in London and Paris began offering Deutsche Mark contracts, and ‘Deutsche Mark securities markets’ grew outside of the country, 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. brokers’ commissions, costs for clearing and settling deals) were relatively high while product innovations offering risk-management opportunities were lacking. 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 monitors to sanction market malpractices. Moreover, German banks were blocked by foreign regulatory bodies when they tried to distribute their product innovations abroad. Member firms of the German Options and Futures Exchange (Deutsche Terminbörse – DTB) were eager to sell their latest financial innovations (= DAX options) to US-based financial firms and money managers. The US SEC, 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 those 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 that they enjoyed at home.

Although German banks still maintained that their model of self-regulation worked, they none the less realized that it had become a major liability in the global competition for investors. In order to participate in the global game, it clearly became necessary to prove one’s fairness and honesty as a financial firm by operating in a tightly regulated market under close state supervision. Suddenly, German banks had an interest in ‘bringing the state back in’ to their regulatory setting. This has become a significant goal, especially since 1990.

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, a regulatory change would not have taken place without the involvement of the German government and, in fact, political forces, growing out of the multi-layered system of interstate relations, also pushed for a stronger role for the German state in sectoral regulation. The Federal Ministry of Finance has faced, perhaps since the mid-1980s, the problem of meeting the
standards of bilateral and multilateral interstate collaboration which evolves around issues of securities regulation. 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 European Union Single Market Programme and in particular the directives on insider trading (1989) and investment services (1993) pushed the process of re-regulation towards a more investor-oriented model in securities regulation. Within the European Union, it was generally Great Britain, the country with the second largest securities market in the world, that joined the bandwagon on liberalization and the re-regulation of its stock exchange market, which had been set in motion by the United States in 1975. On the European level, Germany was in a minority position: 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 malpractice. 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. In July 1989, when the majority of other member states had undertaken legislative action to sanction insider trading or were prepared to do so, Germany still rejected legislation on these matters and faced the likely scenario of being overruled when the directive was examined in the Council of Ministers. However, the key domestic actors were unwilling 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 mentioned earlier, both directives required member states to set up domestic supervisory agencies for the securities sector which would be willing to collaborate closely with their foreign partners. 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 adjust their systems of sectoral governance institutionally to international standards.

Finally, additional pressures, deriving from Germany’s membership in IOSCO, drove the Germans to adapt to the international regulatory standard. In contrast to the Basle Committee, its counterpart in international banking regulation, IOSCO is larger (115 members in 1994) and more formalized internally. There is a hierarchy in the governing committee structure and 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, ranked partly according to their public or private status. Private bodies like stock exchanges could
themselves be members of IOSCO, but, as affiliates, 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 stock exchange delegates. In 1990, the Federal Ministry was asked to take over membership of IOSCO, but it lacked the technical expertise for dealing with the details of securities regulation. German representatives once more found themselves unable to collaborate.

THE NEW MODEL OF SECTORAL GOVERNANCE – TOWARDS FURTHER CENTRALIZATION OF THE SYSTEM

Faced either with an obvious loss of business or with 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 to product innovations and to the transaction costs of their dealing operations, German banks engaged in rationalizing market transactions and integrating the organization of clearing and settlement facilities, together with trading in the most liquid shares. In order to control this process better, the big three universal banks (Deutsche-, Dresdner- and Commerzbank) and the central bank of the savings bank sector, the Deutsche Girozentrale (DGZ) – all members of the board of the Frankfurt Exchange – pushed for a centralization of the German stock exchange sector. 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, using its market power in order to restructure the German financial marketplace according to its interests. Starting with the foundation of the German Options and Futures Exchange (DTB) in 1990, this coalition launched further steps towards sectoral centralization. The formation of this exchange meant not only the introduction of product innovations in Germany since it reintroduced derivatives trading, but also the first fully computerized national exchange in Germany, and therefore it broke with the regional principle of stock exchange organization. In order to raise capital for the process of restructuring, in 1991 the large banks founded the Deutsche Börse AG, a common joint-stock company. 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. A struggle between the Frankfurt coalition and the regionally oriented actors preceded the formation of the new organization, since Frankfurt first proposed that their member firms, not the regional exchanges, should become shareholders of the new joint company. In the mean time, the Frankfurt coalition has become broader and today includes Düsseldorf and München as the next largest exchanges as well as Berlin, the German capital’s exchange. From the viewpoint of Frankfurt, these partners represent the dedicated survivors of its new project of replacing floor trading with electronic trading by the end of the century. Of crucial importance for the future of the smaller exchanges was the fact that the four partners decided to share a common order book, in which trading of the most attractive one hundred DAX shares was divided between them, with Frankfurt acquiring the first thirty equities.
It is obvious that the smaller, regionally oriented actors are the likely losers in this distributional conflict. Smaller exchanges cannot rely solely 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 of centralization, are lacking. The German Länder governments (except Hessen) are eager to express their political will to preserve a federal stock exchange market. They fear losing regional and also larger businesses who at present support their regional exchanges. Nevertheless, the Länder are unwilling to intervene and leave the decision about the future of the regional structure to the market. Given the power differentials in 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, had lost their incentives for upholding it. The losses and gains of share dealing were no longer defined on the home market but on the global one. From the viewpoint of global players, arrangements seeking to distribute losses and gains among the circle of domestic firms were becoming obsolete, particularly if they imposed the costs of collaboration on those actors who had become the object of global competition: the investors.

Meeting standards of international competitiveness, however, required more than simple market restructuring. From the viewpoint of 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 work on bringing it into the system of sectoral overview. Additional pressures on the Federal Ministry of Finance came from the supranational level since the approval of the European Union 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 announced further promotion of the 'Finanzplatz Deutschland'. The need for a new market supervisory body located at the federal level was stressed and further regulations protecting against insider trading and providing for equal treatment of shareholders were proclaimed. These decisions were basically the outcome of consultation with members of the Commission of Experts for Stock Exchange Matters, 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 who 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 oversight problem, modelled on the US SEC. Similar to the fall 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, collapsed 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 co-decision rights in Stock Exchange Legislation that permitted them to decide on the passing of the new law, known as the Second Financial Market Promotion Law. The German states used this powerful resource to lobby for 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. Turf battles took about one year and finally the Federal Ministry came out as the winner of 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 Federal Ministry of Finance (Bundesaufsichtsamt für den Wertpapierhandel). Its tasks involve the surveillance 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 the respective securities exchanges was expanded, a new Securities Council (Wertpapierrat) was founded, nearly identical to the existing working group of states, to give advice but not to 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 is 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). Regulatory practice has shown that direct contacts between the federal level and the stock exchange level prevail; 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 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 to information and transparency in market transactions. 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 oversight has become a critical factor that allows access to new foreign markets. Shortly after the new supervisory body began its work in January 1995, members of the German Options and Futures Exchange were allowed to promote and sell their latest financial innovation (= Future Contract on the DAX) to US-based firms. In March 1996, Germany was permitted to set up computer terminals with the German electronic trading system in the United States.

The German federal government, on the other hand, did not participate actively
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in the first stages of sectoral reorganization. But once it faced a threatening loss of reputation and influence over the politics of securities regulation on the international level, it decided to push also for a greater role for 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 co-operative agreements were signed between the German supervisory office and foreign regulatory counterparts, the first among them being those with the US SEC and the Commodities Futures Trading Commission of the US.

THE REVIVAL OF THE NATION-STATE?

First, empirical findings clearly indicate that states continue to play a key regulatory role in the era of financial internationalization (on this point, see also Underhill 1991; Kapstein 1994; Helleiner 1994). The chances of Keynesian fine-tuning of economic policies have been considerably reduced by highly mobile capital, but this 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 up and monitored – tasks which obviously cannot be fulfilled by the market participants themselves. It is 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. The state is therefore back again by ensuring transparency, fairness and access of markets through legal penalties for non-compliance. In this sense, the new state functions very much resemble the functions provided by the liberal state of the mid-nineteenth century (Panitch 1996). As ‘competition state’ (Cerny 1993), the state of the late twentieth century allies with those economic actors who profit most from the territorial expansion of markets and, by using its own resources to support its domestic constituencies in the global competitive race, the state becomes the pre-eminent champion of globalization.

The German case reveals that new state functions have been very much generated by mechanisms outside the domestic realm. It is obvious that institutional reforms would not have come about without the increasing embeddedness of the German financial marketplace in the international political economy. Both German banks and government are players in an international game whose rules have apparently been changed: competition for institutional investors is the guideline for restructuring the sectoral order and domestic actors are striving to make their system compatible with the new challenge. That the new international game does not lead to a ‘race to the bottom’ in terms of standards of investor protection is important and must be explained. However, the dynamics of this process fit into what David Vogel has characterized as the ‘California effect’ (D. Vogel 1995): regulatory competition can promote a ‘race to the top’ if the country which exports the high regulatory standard is of a considerable size and has a large domestic market. The trading partners are then forced to meet those standards in order to maintain or 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. In this case, both the market power of institutional investors and the bargaining power of the SEC in matters of regulation were the key forces of the international diffusion of the American model of stock exchange regulation.

On the domestic level, German banks and the federal government formed the core of a coalition of globally oriented actors which placed the need to meet international standards of regulation at the centre of the debate. This is not to say, however, that international forces would determine the strategies of domestic actors; the case has also revealed severe conflicts between those actors who profit from the territorial expansion of markets and those who do not. But since the former group now allied with foreign investors or foreign regulatory agencies, the latter is left behind. Not surprisingly, domestic coalitions which in the past had upheld the model of sectoral governance were breaking down.

The large German banks now linked up with foreign institutional investors instead of their former regional partners. From their perspective as global players, domestic cartels were 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. The same forces undermined the former system of sectoral self-regulation: a regulatory model based on ‘tacit rules’ and relations based on trust 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 misbehaviour on the part of financial intermediaries. Thus, for reasons partly to do with the credibility of market regulation, market actors were interested in delegating supervision of the rules of the market game to the state, whose legitimacy as monopolist of violence has not yet been questioned.

The federal government, on the other hand, faced the increasing need to participate in the growing network of interstate collaboration. While the state’s embeddedness in the international system clearly reduced its autonomy in formulating regulatory policies, new tasks of monitoring and enforcement of negotiated rules have been imposed on the nation-state. On the domestic level, however, new tasks of market supervision have 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 the international playing field is negotiated (see Deeg and Lütz 1996 on the implication of financial internationalization on federalism). 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 (see Majone 1993 for their role in an EU context). Since they are staffed by 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 world-wide 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’.

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NOTES

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2 In Germany, the one hundred most liquid shares are part of the German share index ( = ‘DAX’).

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

4 In contrast to Sobel 1994, who traces the financial market reforms of the United States back to the unravelling of domestic financial cartels in the context of a changing economic landscape.

5 See also Genschel and Plümpner 1996 for the study of the different logics of ‘races to the top’ and ‘races to the bottom’.

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