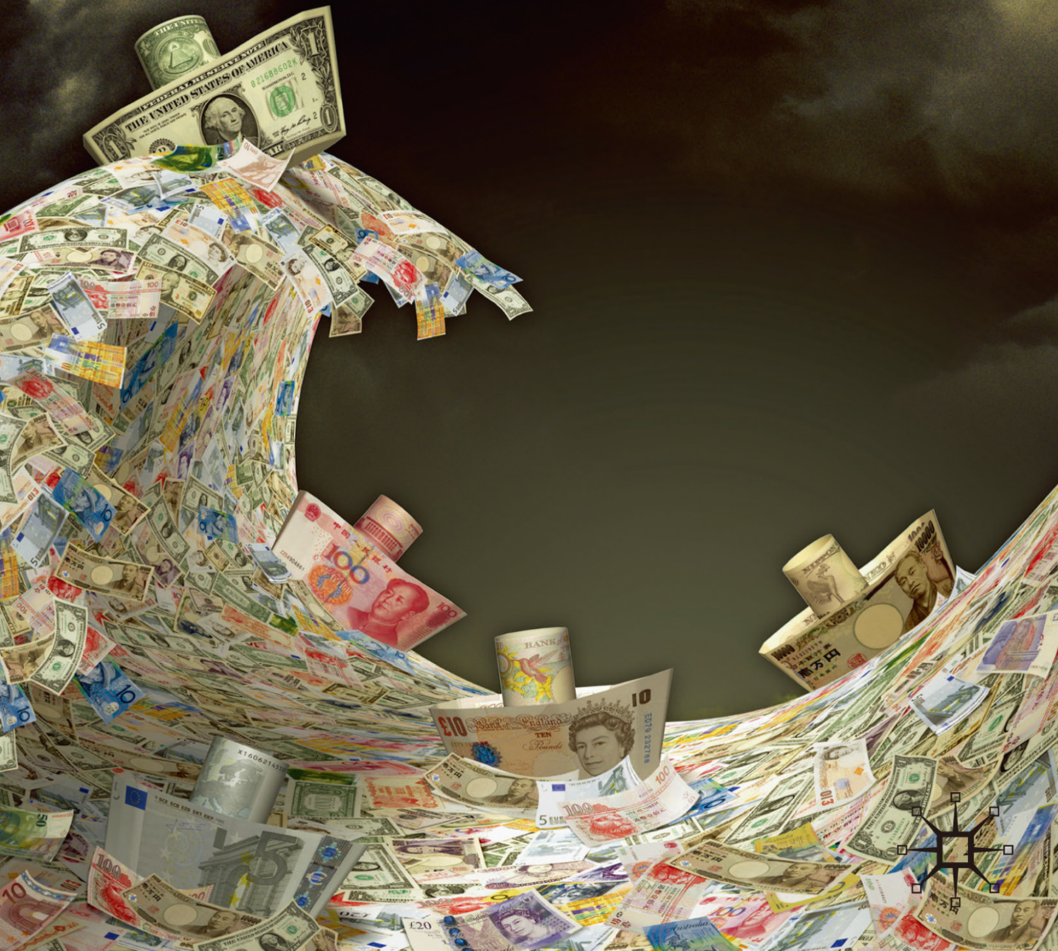
GLOBAL POLITICS & FINANCIAL GOVERNANCE

RANDALL GERMAIN



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Dedicated to the memory of

Helga Germain
and
Susan Strange

two pioneers who lived their lives on frontiers
and left the world better off than they found it

Contents

List of Abbreviations

ABS	asset-backed security
ABCP	asset-backed commercial paper
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BRIC	Brazil, Russia, India, China
CAC	collective action clauses
CDO	collateralized debt obligation
CDS	credit default swap
CFR	Council on Foreign Relations
CSO	civil society organization
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EMU	European Monetary Union
EPU	European Payments Union
ERM	Exchange Rate Mechanism (EU)
EU	European Union
FASB	Federal Accounting Standards Board (US)
FDIC	Federal Deposit Insurance Corporation (US)
Fed	Federal Reserve Board (US)
Forex	foreign exchange markets
FSA	Financial Services Authority (UK)
FSB	Financial Stability Board
FSF	Financial Stability Forum
G-7	Group of Seven (industrialized countries)
G-8	Group of Eight (G-7 + Russia)
G-20	Group of Twenty (finance ministers and central bank governors)
G-20 (leaders)	Group of Twenty (heads of state)
G-30	Group of Thirty (private sector lobby group)
GSE	government-sponsored enterprise
IAIS	International Association of Insurance Supervisors
IBRD	International Bank for Reconstruction and Development
IASB	International Accounting Standards Board
IFI	international financial institution

IIF	Institute of International Finance
IKB	IKB Deutsche Industriebank (Germany)
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPE	International Political Economy (academic discipline)
IR	International Relations (academic discipline)
KfW	KfW Bankengruppe (Germany)
LIBOR	London Inter-Bank Offered Rate
MAI	Multilateral Agreement on Investment
MBS	mortgage-backed security
OEEC	Organisation of European Economic Co-operation
OECD	Organisation for Economic Co-operation and Development
OTC	over the counter
SEC	Securities and Exchange Commission (US)
SDR	Special Drawing Rights (IMF)
SIV	structured investment vehicle
TALF	Term Asset-Backed Securities Loan Facility
TARP	Troubled Asset Relief Program
UK	United Kingdom
US	United States of America
WTO	World Trade Organization

Preface

Every book is a product of its time and context. This book was prompted by those turbulent months during 2008/09 when the world's industrialized economies experienced a remarkable full-scale seizure of their credit markets. Long-established firms went bankrupt, governments committed unprecedented sums of money to support banks and other financial institutions, and indeed some countries witnessed the near collapse of their entire financial systems. Although what became known simply as the 'credit crunch' began in the summer of 2007, it did not assume its historic shape until late 2008, and peaked during the early months of 2009.

This book was written in the shadow of that tumultuous period. Its impetus is a deep dissatisfaction with how this crisis has been portrayed. There are two critical elements to this dissatisfaction. On one hand there is a denial of the long sweep of history, a kind of herd myopia about how we got to the point where credit markets could no longer place any trust in the value of financial assets, which of course undermines completely the normal movement of money between counterparties and the extension of credit from those with savings to those who desire to make investments. This denial of the fundamental importance of history also extended to the peculiar overuse of the term 'historic', which was inherent in the tendency to equate the crisis of 2008/09 with the worst years of the Great Depression, still the key formative social event of the past century. History has been both denied and abused in the rush to make sense of the credit crunch, and this book is written in the hope of ameliorating the worst excesses of that tendency.

On the other hand, the credit crunch has been most often considered predominantly as a *financial* event, as a crisis of the financial system understood in narrow terms as simply that system which creates and exchanges financial assets between institutions and among economies. While the 2008/09 credit crisis is of course a crisis in this very specific sense, a broader view of finance is also necessary if we are to capture both the complexity of what has transpired and the enormity of its meaning for how we will live out our economic, political and social lives over the foreseeable future. And while governments everywhere struggled to regain control over the creation and extension of credit throughout their economies, the broader issues presented to society by the credit crunch – or the Great Freeze, as I shall describe it in Chapter 4 – remained dormant, waiting to be articulated so that they could become part of the debate about what this crisis means and how we can insulate the future from a repeat performance.

Above all, this crisis has been a crisis of uncertainty; it has unleashed on the financial system the modern day equivalent of a new and virulently contagious bacterium whose diagnosis and treatment we have not yet quite figured out. It was in effect fought with tools designed for other diseases or a previous era, much as generals almost always re-fight the last war. Perhaps this is what must occur before a proper treatment can be formulated. But it will be necessary to understand the complex linkages between the credit crisis and broader political, economic and social developments if a proper treatment is to be formulated, and this book is written in the hope of contributing to our diagnostic effort by drawing our attention to some of the broadest and most historic of these linkages.

If there is a model for such a book, it is Karl Polanyi's classic account of the deep-seated transformation that gripped the industrialized world during the first decades of the twentieth century. He did not write that book as a testament to scholarship and learning; instead, he wrote it to alert people to the fundamental dynamics pushing the organization of political and economic life in new directions. *The Great Transformation* is a deeply historical manuscript, even if one can point to many errors of historical fact in its pages. It is also single-minded in its pursuit of a mono-causal analysis, even as it acknowledges the many limitations such a form of reasoning presents. Some of these same faults will be found also in what follows here, although I substitute Polanyi's preoccupation with a mono-causal account with one that is distinctly multi-causal in tone. However, like Polanyi, I can only plead for patience because of the message that this work offers.

This message focuses squarely on the relationship between politics and the economy, or more specifically on the relationship between polity – or the state, to use the term I will employ throughout – and the financial institutions active in the market. This message demands that we recognize how this relationship has both developed over centuries (and therefore is, as scholars like to say, highly *path dependent*) and is constrained in important ways by choices we have made to organize our political lives through particular institutional forms. We cannot undo these forms without dismantling long-held and cherished beliefs about the role politics should play in our lives. These beliefs and the institutions they have spawned are the ultimate check on the tyranny of finance. It is one of my contentions that this crisis represents an opportunity to turn a corner in the long-established tug-of-war between our desire to make money and our need for balance in society. It is also an opportunity to recognize the unique advantage that national institutions bring to the agenda of financial regulation.

This book is written to be as widely accessible as possible, and to that end its starting point is an account of the evolution of the relationship between finance, states and financial regulation that traverses the main historical periods and turning points in order to establish their necessary political, economic and social contexts. This occupies the first four chapters of the book, and provides a solid foundation from which to engage with the theoretical issues, principles and assumptions that are the subject of Chapter 5. To facilitate accessibility, I have restricted the use of endnotes and references (which are mainly used to indicate the sources of key ideas or for further explication of the technical or more arcane points raised in the text), and I have written a guide to further readings at the close of the book which indicates both a more thorough selection of the academic work that I have drawn on as well as the kinds of sources I have used for the empirical or factual parts of each chapter. This reference guide is written as a bibliographic essay, and it identifies where interested readers can go for more debate on the issues raised in the book.

Even though this book is not written for a traditional scholarly research audience, I hope it will be used by them and especially by their students, for whom the idea of making broad connections in order to understand important themes and events is usually highly valued. This book would make a good companion to more specialized texts in business schools and across a wide range of college and university programmes – in political economy, economics and international politics, for example – where students are being introduced to the basic building blocks of the contemporary global economy. I have written it in particular for students who, like many upper-level students who enrol in my senior year seminar on the political economy of global finance, just want to learn *about* finance, but without also having to learn the arcane language deployed by finance 'anoracks'. But I have also written it for those finance specialists and professionals who, although they may be steeped in the technology of finance, also wish to acquire or be exposed to the history and politics that have generated today's global financial system (and its periodic crises). Together these two target groups may not constitute an enormous audience, but they certainly are an important and enduring one.

Acknowledgements

No book is written only or even primarily by its author, even if it is they who spend the many hours necessary to actually produce the end product. For their sins, I wish to acknowledge the many people who have prodded me into writing this book and provided feedback along the way. Jeremy Paltiel – a Carleton colleague – demanded that I write this book after listening to me give a talk at Carleton University to a group of undergraduate students interested in International Relations. I denied the logic of his entreaties as long as I was able, but ultimately capitulated. At Palgrave, Steven Kennedy has been urging me to write such a book for years, and has assisted it into print in any number of small and important ways. One can only resist such a force of nature for so long. My thanks also go to Keith Povey and his colleagues for their editorial help with the final manuscript.

Several graduate students at Carleton University have also assisted me along the way by conducting research for related projects and grilling me mercilessly on my arguments. They have also, through their tireless enthusiasm, convinced me that such an undertaking is more than worthwhile. For their help in tracking down relevant literature, assembling statistical material, and otherwise encouraging this work, I would like to thank Elizabeth Cobbett, Judit Fabian, Elizabeth Friesen and Bart Paudyn. Each of these doctoral students is currently engaged in important research on the organization of the world's financial system, and our understanding of this organization will be much improved as they complete and publish their findings.

Many others have over the years given generously of their time and advice with respect to related research which, in many forms, has found its way into this book. Much of this constructive criticism has come from conference and workshop presentations where interventions and questions have been scribbled down, digested and then fed back into my research at later points. So many have contributed in this way that here I must be content simply to acknowledge the wonder that is the scholarly process.[1] Additionally, many others have directly commented on or discussed with me issues related to the research upon which this book builds. I wish here to record my appreciation and thanks to all who have in a very direct manner helped me to think and write about the political economy of finance over the past decade: Rita Abrahamsen, Andrew Baker, Bob Cox, Mike Dolan, Sophie Hague, Eric Helleiner, Stephen Hughes, Michael Kenny, Oliver Kessler, Kathryn Lavelle, Robert Lombardi, Abdulghany Mohamed, Craig Murphy, Robert O'Brien, Jonathan Nitzan, Liliana Pop, Tony Porter, Herman Schwartz, Guy Scuffham, Leonard Seabrooke, Stuart Shields, Andrew Walter, Rorden Wilkinson, Howard Williams, Michael Williams, Geoffrey Underhill and Kevin Young. And although it might seem unfair to do so, I feel compelled to thank Eric Helleiner in one additional way to that indicated here: he is an amazing repository of little-known facts about almost anything to do with finance; knowing him is akin to having a personal global financial archivist at your disposal.

Beyond this, a few hearty souls have read either the entire manuscript or very large chunks of it, and have provided helpful and pointed feedback. For the time taken to do this, which truly is a step above and beyond the call of duty and friendship, I wish to record my gratitude and thanks to Bob Cox, Katie Lavelle, Brian Schmidt, Herman Schwartz and Tim Sinclair. The enthusiasm with which they took up my request, and the quality of the comments they provided, have improved this manuscript considerably. In addition, two serious and critical reviews from Palgrave Macmillan further pushed me to sharpen the organization and writing of the book. Of course, none of the above will fully agree with how I have responded to their helpful and constructive comments (every author after all is entirely responsible for their own text), but this manuscript is much the better for their sage advice.

And I would be remiss if I did not also acknowledge and properly thank the many agencies and institutions which have contributed to this work, even if indirectly. To write a book like this one has to have conducted an extensive amount of prior research – in this case constituted primarily by interviews among senior decision-makers in financial institutions, central banks, ministries of finance, national regulators, international institutions and civil society organizations – over a number of years. This I have done, and it has been funded by four academic funding agencies: in the UK by the Nuffield Foundation, the British Academy and the Economic and Social Research Council, and in Canada by the Social Science and Humanities Research Council. Funding from these agencies facilitated my travel to developed and emerging market economies to discuss with many people issues associated with financial governance for the past decade. Newcastle University, the University of Wales, Aberystwyth, and Carleton University have also provided funding that, together with that provided by the aforementioned agencies, allowed me to organize workshops and attend conferences where my academic work received rigorous scrutiny from my peers.

Finally, authors receive succour and support not only from their peers, but also and even more importantly from their family and friends. In my case I have a large circle of family and friends that has been both amused and sceptical about my chosen profession, and to all of these I express my appreciation for their support and interest in my work over the years. But my immediate family is without question the greatest source of support in my life. They are probably still in shock that this book has actually been completed and published in my lifetime, much less written over a single year; one can only threaten to write so many books before that bluff is called! At any rate, I am deeply grateful for the support which Cindy, Elyse, Bronte, Rowen and Kyla have given to me over many years, but none so crucial as from January to December 2009 when this book was written.

I close by dedicating this short book to two remarkable women who did not know one another but who in very different ways have had an indelible impact upon my life. Susan Strange, whose work features in much of what follows, was a long-time critic of 'casino capitalism' even if she refused to abandon the belief that a properly organized, market-based financial system was of net benefit to society. Her inspiration to at least two generations of scholars in International Political Economy will not quickly be forgotten. And my mother, Helga Germain, who passed away just as this crisis was heating up, similarly inspired in me a determination to just get on with the job at hand, wherever that may take you, while at the same time never forgetting your roots. Both she and Susan Strange would appreciate that, as in governing finance, serious trade-offs are required to make life work, but that with a bit of thought and some grit they can be made. It is to their exceptional pioneer spirit that this work is dedicated.

Ottawa, Canada RANDALL GERMAIN

1

Financial Governance and the State

Introduction: the Significance of the 2007–2009 Credit Crisis

The wholesale financial carnage wreaked upon the world between mid-2007 and mid-2009 has prompted many to ask whether global finance is out of control. How could financial systems from America and Iceland to Russia and Hungary have been so mis-governed that their near collapse would plunge the entire world into recession, the first such global measurement since 1945?[1] What needs to be done to minimize the chances of relapsing into another such state of affairs, and if something can be done who will do it? And finally, what will the future look like, and how (not to mention by whom) will it be 'made'? These are the questions which animate this book, and they are neither easy nor straightforward ones to settle. But as the world's economies come out of recession and resume growing in 2010, answers are needed if another repeat of financial chaos is to be avoided.

I provide two kinds of answers to the question of how financial systems should be governed so that a recurrence of the credit crisis of 2007/2009 is minimized. First, there needs to be a clear recognition that financial governance is most effective when it is organized predominantly at the national level. This is where the lines of oversight between regulators and their subjects are robust and unambiguous, and where the lines of accountability between regulators and political institutions are most transparent and effective. It is where the necessary connection between politics and finance is most clearly visible and amenable to active and deliberate modulation. If citizens are concerned about how financial systems are organized and how they relate to democratic politics, locating the centre of regulatory gravity within the nation-state is an indispensable and indisputable first step. Regional arrangements are also significant here, and this permutation (together with its quirky politics) will be explored in Chapter 6.

Second, the proliferation and design of financial instruments needs to be better regulated so that entire financial systems are not capsized if one class of instruments – or indeed one part of the financial system – suffers undue stress or comes unhinged. What is remarkable about the 2007/2009 credit crisis is the manner in which one part of the American economy, the housing market, which constitutes perhaps 15% of the overall American economy, came to exert such a profound influence on its financial system. But even more astonishing was the fact that through the mechanisms associated with mortgage finance, a crisis that originated in a sub-sector of the housing market (the sub-prime sector) spread quickly throughout the entire American economy and from there through the global economy. I argue that one of the chief means by which this was done was through the creation and distribution of financial instruments that ultimately distorted not only the entire American financial system, but also (via the resulting macro-economic imbalances) the world's financial system as well. Clamping down on these twin problems, while difficult, will be a central concern of the post-crisis period.

At the general level, then, my basic argument can be summarized as a call to reinforce the regulatory capacity of nation-states, and to restrict the ability of financial institutions to create, sell and use certain kinds of financial instruments. As such, it is a counter-intuitive argument that suggests policy-makers need to move in a direction that runs counter to major developments over the last half-century. The history of the post-World War II period is one that can be told largely as a story of the liberalization and globalization of financial markets and the firms that operate in them. It is a story, as relayed in Chapters 3 and 4, in which capital has become progressively freer to organize itself in order to operate on a global scale. Governments have played an important role in this story, first by facilitating this freedom through domestic capital market liberalization, and then by responding to the consequences of this liberalization through the development of international measures to build up a quasi-global regulatory infrastructure.

Yet, as the 2007/2009 credit crisis reveals, this infrastructure is incomplete and on several measures almost useless in the face of real crisis conditions. Whereas past crises have resulted in improvements in these measures, the depth of this particular crisis, and the way in which it has been addressed, suggest that its limits have been reached. Short of establishing an independent global banking or financial authority – of the kind that has been proposed in the past (Eatwell and Taylor 2000)– we are better off now to embrace a strengthened set of national or regional regulatory regimes, supported and buttressed by a limited set of international cooperative mechanisms which have no global aspirations or illusions. This is the central insight generated by a global history of financial governance.

For the future of the global economy, the implications of my argument are twofold. The first is that national governments will remain and should be understood to be the central locus of authority in the global economy. As a result, it is more accurate to refer to the global economy as the global *political* economy, to reflect the centrality of the state (and perforce of politics) to its constitution. The most important point here is that the nation-state is not, as a famous economist (Kindleberger 1967: 207) once quipped, just about through as an economic unit; rather, it is about to re-emerge after several decades as perhaps the central authoritative element of the economy. The argument for 'big government' may wax and wane, but the argument for 'necessary government' is here to stay, and especially so in active democracies.

The second implication is that the high point of globalization has now been reached, and that the tide of globalization is about to be rolled back, led most importantly by the containment of financial systems through efforts to tighten how banking systems and capital markets are regulated. But this containment will also have other elements. It will derive in part from the necessary adjustment of open economies to the imperative of domestic-led growth. And it will be supported by the many initiatives that emerging and developing economies will take to reduce their vulnerability to crises in industrialized economies. I call this process *deliberalization*, and describe and explore it in Chapter 6. The end result will be a global political economy that is better balanced in terms of its trade and capital flows.

If more balanced and sustainable growth in the global political economy is the principal upside to deliberalization, one clear downside to this development will be a period of undeniably slower growth in some parts of the world over the next several years. We who live in the rich industrialized and in some parts even post-industrialized world, will become (collectively) richer more slowly than in the past. This means in part that the issue of how to distribute the benefits of growth (and wealth) will re-emerge as a salient political issue. Whether this comes out as a demand for better welfare provision, or more extensive healthcare coverage, or higher (or lower or fairer) taxation, or enhanced pension provision among ageing societies, is not really the critical point. Instead, it is crucial to recognize that the highly charged political question of how wealth in the rich world should be distributed will become much more potent than the question of how to grow that wealth. A rising tide may lift all boats, but when the tide is receding or stagnant, where your boat is moored becomes crucial. We are about to become very concerned about where our boats are moored.

In the developing world of emerging market, middle-income nations such as South Africa, India and Brazil, this downside will be attenuated by the very real growth they will experience as their populations become more educated, mobile and above all productive. While the rich world grows more slowly, these countries will continue to grow as they have over the past decade, reaping windfall effects from the limited liberalization they have already undertaken together with the 'virtuous cycle' net effects of having more money to invest in their own industrial infrastructure. They will of course also have to invest in welfare, education, health and the environment, but the returns from those investments will far outpace similar investments in the rich world. And they can do this by and large on their own, with a controlled integration with rich economies that reduces historical vulnerabilities while accentuating positive linkages.[2]

There will therefore be a positive aspect to deliberalization and the rollback of globalization. But I want to be clear here: my argument is not that the 2007/2009 credit crisis has ended globalization, much less that it has revealed global capitalism to be a sham. Instead, I argue that this crisis has amply demonstrated (yet again) how important nation-states are to the general operation of the global political economy. Nation-states – and especially the most powerful among them – are absolutely and critically necessary if the global political economy is to regenerate its own conditions of existence. Furthermore, it is difficult to defend the intrinsic merit of a 'global' political economy that is plunged into crisis every ten years or so, suddenly making tens or indeed hundreds of millions of people poorer or much worse off, with all the attendant social problems connected to such occurrences. It is much more defendable to work towards building a global political economy that enjoys a more sustainable balance, where wealth grows perhaps more slowly overall, but in a more even and less vulnerable pattern. Such a pattern, however, cannot be left to market forces alone. To achieve a responsible and sustainable type of globalization requires an active nation-state, and such a state will make a point of constraining the malign consequences arising out of the 'normal' operation of the world's financial systems.

Finance, Governance and the State

This is a book about the organization and governance of the global financial system. To speak about the global financial system is to identify a bundle of institutions and their collective interactions that create, allocate and facilitate the use of a resource commonly called money. Money has a deep and intimate connection to finance, but finance is more than money because money is often portrayed as a physical thing, or at least as something that can be easily translated into a physical object. This idea lies behind the standard economic definition of money as either a *unit* of account, a *medium* of exchange or a *store* of value. Whichever definition is appropriate, money can be represented as a concrete, specific object that can be identified, pinned down and counted. You either have it or you do not.

By contrast, finance goes beyond money to incorporate elements of time and what should perhaps best be understood as inter-subjectivity. The idea of finance helps us to connect the uses made of money at different points in time, because finance is the particular way in which this temporal dimension is organized. For example, a distinction is often made between bank-based and capital market-based financial systems, in which one of the key differences is understood as long-term versus short-term commitments from lenders to borrowers: bank-based systems foster longer-term commitments between borrowers and lenders, while capital market-based systems, by some accounts, encourage shorter-term thinking. Another way of making this point is to recognize that finance is in part about how access to money is organized over time. A long-established maxim about banking recognizes how banks borrow short to lend long, meaning that they accept deposits (or purchase money) for short durations but lend it over longer-term horizons. This temporal factor is one way that money is transformed into finance: money + time = finance.

But this formulation still accepts that the value of money is easy to understand or establish, when in fact the value (or price) of money is possibly one of its most quixotic elements. How do we know what the value or price of money is today, and how can we be sure of what it will be tomorrow? This is where the inter-subjective dimension of money becomes acutely significant, for the factors that determine the value of money are not easy to establish. How money gets valued is subject to many influences, some of them easy to quantify, others less so. What factors, for example, influence the current value of the US dollar? Government finances are one, trade/current account/capital account balances are another, while investors' perception of the determination of American taxpayers to support their military's activities in Iraq and Afghanistan might be a third. But the so-called flight to quality that saw a dramatic surge in the value of the greenback in the third quarter of 2008, just as American banks and the American financial system were being hammered by the credit crisis, is difficult to explain on any basis that excludes an inter-subjective consideration of future projections of American financial and political (will)power.

This inter-subjective element is entirely about what people in their capacity as investors, savers and spenders believe about different possible future states of affairs. It is not so much about hard cold numbers (although these are not unimportant); rather it is more importantly about what people collectively determine to be important and likely to transpire (or not). It is about beliefs and the purposes to which beliefs are put, whether at the individual or collective levels.[3] Finance on this reading is centrally concerned with how people organize their access to money on the basis of the many and varied purposes to which they believe that money should be put. We should therefore understand that financial systems incorporate a significant amount of inter-subjective purpose in their organization, and that this inter-subjective purpose helps to determine how money is organized, what kinds of value it may possess at certain points in time, and in what directions its organization should be pushed when it is revealed to be deficient. We need therefore to amend our formula as: money + time + inter-subjective beliefs = finance.

It is the existence of institutions that allows these ideas about time and inter-subjectivity to be connected to money. Financial institutions and their interactions are what connect this physical thing called money to our access to it: they are 'finance', or at the very least, they allow 'finance' to occur. Such institutions take many forms. They can be banks (whether commercial, mortgage or retail), investment banks, pension funds, mutual funds, hedge funds, stock-broking firms, venture capital firms, insurance companies; indeed, they are any firm that either creates financial assets or acts as a medium to bring together those who have savings or liquid assets with those who are in need of them. All of these institutions peddle perceptions and values: they are the means and the link by which *money* becomes *finance*. This provides us with a good working definition of a financial system, which should be broadly understood as that set of institutions through which access to financial resources is organized.[4]

For many years it has been common to consider financial systems to be organized around some combination of four pillars, each with their own predominant type of institution. The first pillar is composed of banks and banking systems, which are primarily concerned with the organization of the overall savings pool in an economy, and the channelling of savings to investors through mediated borrowing. This is why the banking system is understood to be a system of *intermediation*.[5] The second pillar is associated with the operation of capital markets, and includes securities firms, investment banks, and all manner of active 'funds' (hedge, vulture, mutual) which in one way or another help to channel savings into equity investments in companies, often but not always through the buying and selling of stock in publicly-held companies.[6] By connecting savers to borrowers directly through the operations of capital markets (rather than through a bank), these institutions have often been understood to promote the *disintermediation* of financial services. The third pillar is that sector of the financial system concerned with harbouring resources for retirement, and which because of this operates according to a different time horizon altogether. This pillar is populated mainly by pension funds, which engage in building up long-term assets in order to match them with their equally long-term liabilities on a stable and sustainable basis. The final pillar is usually identified as the insurance business, including retail, wholesale and reinsurance, where protection is provided to people and firms for specified damages by accessing and pooling savings (and fees) in an efficient and balanced manner. Like banks, both pension funds and insurance firms engage in active intermediation, even though they are also deeply associated with the disintermediated operation of capital markets.

It must be noted that these pillars no longer exist as independent or autonomous elements of financial systems, although much of their histories can be read as such for long periods. Today, financial systems are much more seamless than in the past. In many countries, banks own investment houses as well as insurance firms, and of course hedge funds and venture capital firms are relatively new entrants into financial systems. And as these pillars have evolved and merged together, the ways in which they have been regulated or governed has changed also.

As I shall detail, the history of financial governance is long, complex, and not necessarily linear. For our purposes here, it is important to note that the regulation and governance of financial systems has evolved in line with three different kinds of dynamics, all of which are expounded in later chapters. First, regulation has evolved in line with the pillars described above. In other words, as each of the pillars of the financial system has evolved (on their own and in combination with developments in other pillars), so too has their regulation. The history of deposit insurance or reserve requirements, for example, has evolved along with developments among banks and the banking system, whereas the ring-fencing of capital requirements and the protections afforded to insurance firms by their regulators have emerged and evolved as that pillar has changed over the years. And as we shall see, one of the most significant likely changes arising out of the 2007/2009 credit crisis concerns whether financial governance will now step back from this sector-specific formulation to adopt a more macro-prudential or holistic vantage point.

Second, financial governance has evolved in response to economic and especially financial crises. (For an overview of important crises in the modern era, see the box at the end of this chapter.) Certainly over the course of the twentieth century, it is easy to trace the effects of financial crises on the way in which financial institutions and the financial system have been regulated. The most obvious example is the series of regulatory changes introduced by the Roosevelt administration in the US as a consequence of the 1929 Wall Street crash and the subsequent 1933 banking crisis (discussed in Chapter 2). The historical record bears out the claim that financial crisis leads directly to regulatory change, and one of the central questions prompted by the recent crisis is how and in what ways regulation will change in light of the many regulatory failings it has revealed. But in order to provide a convincing answer to this question we need first to consider how previous crises have been related to regulatory change.

The third dynamic influencing the history of financial governance and regulation is the changing capacities of states to intervene in their financial systems. There are two aspects to this relationship. On one hand, there is the practical question of what states can actually do to regulate and/or control financial institutions active on their turf. The answer to this question has changed dramatically over time, both positively and negatively. Positively, the capacity of state organs to intervene in financial markets has grown historically as states have come to absorb a larger proportion of the economy's resources. With states (directly and indirectly) generating between 35 and 50 per cent of GDP in most industrialized economies, and ultimately responsible for the value of national currencies, states now have access to the necessary technology and resources to make their weight felt in financial markets. If modern states in industrialized economies want for whatever reason to intervene in their financial markets, they can (with very few exceptions). But on the negative side, because such financial markets have themselves become increasingly interconnected with markets in other economies, such interventions are often only partially successful and may have unanticipated consequences. The cost-effectiveness of such interventions has been diminishing for all but the most powerful states. The principal reason for this is that the size of globally-integrated financial markets (and their associated networks of financial institutions) has grown so much in relation to the resources of individual states that the cost/benefit calculation of such interventions can rarely be shown to be positive. Indeed, as later chapters will detail, even the most influential financial power – the US – can no longer exert its influence unilaterally.

The second aspect of the changing role of the state in financial governance concerns the different traditions which states have come to follow with respect to *how* they undertake the acts associated with financial governance. Across the world governments have come to organize and exercise financial governance in a bewildering range of ways, even if on the surface they seem to use similar institutions. Few experts, for example, would confuse Britain's FSA (Financial Services Authority) with Japan's FSA (Financial Services Agency), even though they undertake similar activities. And even though the British and American financial systems both depend heavily on the operation of capital markets, the ethos of regulators in each country has for many years differed markedly.[7] These differences are part of the reason that financial arbitrage – the exploiting of regulatory and other differences between markets – remains such a persistent (and lucrative) financial practice.

But the basic point remains: governments (or states, since I shall use the terms interchangeably) around the world differ in how they approach financial regulation, the degree to which they can actually deliver such regulation, and their intent or purpose in providing whatever degree of regulation they deem fit. On top of this are the usual conflicts of interest and purpose that derive from a consideration of international politics – or global or world politics, as scholars in political science are increasingly calling it – relating mainly to the changing balance of power among the world's states, new security challenges facing all states, the disruptions and changes wrought by globalization, and the increasing involvement of non-state groups and movements in what once was the preserve of foreign policy and treasury officials. It is in the intersection between international politics and how governments address the challenges of the recent financial crisis that we can locate the politics of financial governance that are explored in subsequent chapters.

Dimensions of Financial Governance

The problem this book sets for itself is to trace and explore the evolution of financial governance in a manner that integrates developments within the world's financial systems, as they have become articulated, into one quasi-singular totality. Financial systems are and remain the lifeblood of economies precisely because they make available to economic agents the means by which to undertake all manner of economic activities. It is the availability of finance – or credit, as this book prefers – that allows investment to proceed, trade to unfold, housing to be built and consumption to occur. In this sense the political economy of finance, which must include its mode of governance, is an essential aspect of any attempt to understand the trajectory of the contemporary global political economy as well as the current financial crisis.

At the same time, finance in the form of credit makes many non-economic activities possible as well, from giving to churches to the playing of sports to the realization of hedonistic and cultural desires of all types. This is a powerful reason to subject the arena of finance to a broad-based multi-disciplinary form of investigation, precisely because this parallels the multi-faceted role finance plays in our everyday lives. This is a key premise of this book: that finance is ubiquitous in the organization of the modern political economy, and that its study demands a framework that is contextually and behaviourally relevant to this role.

For this reason I define finance as the entire network of institutions which facilitate access to credit resources, the value of which is contingent upon the many and complex relations between and among these very same networks of institutions. We may thus say that the subject of our investigation is the complex of institutional networks through which credit flows within and between economies. I develop this definition more fully in Chapter 5. For now it is sufficient to note that over centuries, this network has become increasingly global and integrated in its organization, although it remains to a certain extent sedimented in ways which can break up flows of credit and re-channel them in different directions depending upon changing circumstances. Nevertheless, our theoretical cue about what is being governed must follow from the shape and dynamic of insti-