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ABSTRACT

Theory and the Market after the Crisis: the Endogeneity of Financial Governance*

The inheritance of contemporary financial economics invites us to consider financial stability as integral to a liberal market setting. The crisis however demonstrated that financial markets may prove highly dysfunctional in the absence of adequate mechanisms of regulation and governance. This implies that economic theory requires an enhanced understanding of the intersection of economic rationality with the rationality of governance. This article extends the insights of institutional economics to demonstrate that the emergence of the institutions of financial governance is endogenous to the utility-maximising behaviour of competing economic agents. Utility-maximising behaviour and conflict over the terms of competition in the market generate both the formal and informal institutions and processes of governance such as regulation and dispute settlement. The model is illustrated by the case of international finance, predicting forms of policy rent seeking in a market environment: private interests embedded in public policy processes simultaneously reshaped both market and governance in line with their own perceived utility functions. The model predicts that similar policy rent seeking will dominate the reform process. Successful reform will require a conceptual understanding of this link between governance and market competition, and appropriate changes in the nature of the policy process so as to reshape markets to avoid financial instability in the future.

JEL Classification: A10; A12; B25; B26; B52; D02; D21; D23; D53; D71; D72
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Theory and the Market after the Crisis: the Endogeneity of Financial Governance

Much of the inheritance of contemporary financial economics understands financial stability as integral to a liberal market setting. The outbreak of financial crisis challenges our understanding of the stability of financial markets in both theory and in practice, and this paper exhorts scholars to assess what should change in the way that economics is taught to and understood by managers, also inviting reflection on the nature and quality of governance a liberal financial order might require. This paper argues that economic theory requires an enhanced understanding of the intersection of economic rationality with the rationality of governance, yet current economic theory starkly contrasts the dynamics of free markets with the 'political' dynamics of regulation and governance. That distinction yields a distorted view of how real-world economic agents compete with each other and what we should do in terms of policy. Economic theory must better account for the ways in which market actors and their constituencies shape the terms of competition among agents through their governance preferences, and the ways in which states are active constituents of the market place.

This paper extends the insights of institutional economics to develop a new conceptual model demonstrating that the emergence of the institutions of financial governance is endogenous to the utility-maximising behaviour of economic agents engaged in competition in the market. Agent interaction simultaneously generates patterns of competition and the formal and informal institutions and processes of governance such as regulation and dispute settlement. The model hypothesises reflexively that rent seeking rivalry in markets generates actor preferences concerning regulation and governance that set the terms of competition, and that the outcome of conflict over divergent actor preferences concerning governance and

regulation generates changes in market structures. Changes in preferences concerning governance are intimately bound up with preferences concerning market structure.

The model is applied to the case of international finance, revealing the nature and origins of an approach to global financial supervision and regulation the deficiencies of which have given rise to the present economic crisis. Preferences for financial liberalisation and the subsequent establishment of a market-based approach to financial governance constituted a process of policy-rent seeking which yielded important competitive advantages for the international banks and financial conglomerates which pursued this preference-set in the first place. In turn, the adaptation of risk management techniques and of financial supervision directly contributed to the growth of the excess leverage and product innovation associated with the outbreak of financial crisis. The crisis was a direct result of policy rent seeking and capture: private interests embedded in public policy processes simultaneously reshaped both market and governance in line with their own perceived utility functions. The model explains how capture emerges from market interaction and predicts that similar policy rent seeking will dominate the reform process: successful reform will require appropriate changes in the nature of policy inputs so as to reshape markets to avoid financial instability in the future.

1. Theory: the Literature and the Argument

1.1 The 'Standard' View[1]

The economics literature has long been concerned with explaining and indeed promoting markets as a spontaneous extension of human propensities and freedoms. Furthermore, open market competition generates an inherent tendency towards equilibrium among employment, production, and consumption as predicted by Say's Law (Landreth 1976: 107; 110-11),

[1]I use 'standard' in the sense employed by Oliver Williamson (2005), by which he essentially refers to the neoclassical approach; see also Williamson 1985.

thereby enhancing efficiency and maximising aggregate welfare over the long run. This view frequently overrides the direct experience of economic volatility and agent rent seeking behaviours which characterise the day-to-day practice of management. The struggle for the free market as a system of allocation is a struggle against politics and arbitrary intervention.

This 'standard' view underpinned the emergence of modern financial economics and it's modelling of prices, information, and financial stability in relation to risk probabilities. Despite the availability of alternative theories,[2] the Efficient Market Hypothesis (EMH, a clear sub-set of general-equilibrium theory) as supplemented by modern portfolio theory has dominated theory and practice of contemporary financial markets.[3] The theory proposed that the achievement of openness, of transparent information provision, and sound risk management would yield market equilibrium, and so these principles became enshrined in the strategies of financial institutions, of market authorities, and of financial supervisors. This theoretical vision assumes that the model of the competitive economy "is a reasonably accurate description of reality" (Arrow and Debreu 1954, 265), and results in a conceptual dichotomy between the market as exchange, and governance as exogenous coercion.

1.2 Critical Voices Strengthened by crisis

The serial episodes of financial market instability that correlate to ongoing market liberalisation (Bordo *et al* 2001) have provided *prima facie* grounds on which to challenge this prediction of stability and equilibrium. Fortunately, there has always been literature sceptical of both the market equilibrium argument and of a strict separation of our understanding of markets and institutions. Coase (1992: 714) pointed out that economics has

[2] For example Minsky's financial instability hypothesis (1982), or for that matter Keynes (see Minsky 1975).

[3] See discussion of the emergence of contemporary financial economics in Taylor (2004), esp. pp 241-264.

largely consisted of increasingly abstract formalisation of what is claimed to be Smith's central idea that an economy could operate in an orderly fashion free of government regulation and central planning. "Sometimes, indeed, it seems as though economists conceive of their subject as being concerned only with the pricing system and that anything outside of this is considered no part of their business." The economics literature employs both theory and empirical research methods to develop this contrast between market versus non-market or 'political' systems of allocation, basing the distinction on the 'observable' behaviour of economic agents and the nature of market outcomes. Although powerful business organisations have long been central to this system of prices, the notion of organisation fit poorly with the theoretical model on offer so the less that was said of it the better.

Contrary to neoclassical economics, both Arrow and Williamson claim that market and non-market processes, while fundamentally different, are potential if imperfect substitutes for each other. Arrow (1974, 15-43; 53; 69) argued that organisation and institutions emerge as substitutes for market allocation when the price system fails for a range of reasons. This may involve a range of tradeoffs in terms of efficiency because organisations sometimes prove less than adaptable over time. Williamson (1975, 1985) went further: institutions emerge as efficient solutions to the problem of high transaction costs. Non-market forms of organisation may emerge to assume the function of allocating scarce resources more efficiently than decentralized exchange, although each of these "alternative contracting modes" (Williamson 1975, 253) remains a very different *kind* of allocative process in and of itself.

In short, there is some underlying relationship between markets and institutions which theory should capture. Krueger's classic article on rent seeking behaviour explores this relationship further: "government restrictions upon economic activity are pervasive facts of life," (Krueger 1974: 291). Despite the costs that this institutional interference with the

market mechanism implies (299; 302), agents and/or producer groups may *benefit* from the associated rents to the extent that they will deploy resources and compete to establish forms of intervention in the very market mechanism in which they are involved (Krueger 1974, 292-3). Rent seeking becomes part of economic behaviour along with production and distribution.

It remains a paradox as to how competitive rent seeking is part of the economic game, yet the result represents exogenous intervention in the market competition of which it is part. The next section demonstrates that this competitive policy rent seeking and market rivalry both emerge symbiotically from the utility-maximising behaviour of economic agents.

1.3 The Contribution of Institutional Economics

The institutional economics literature began by explaining the emergence of the firm (Coase 1937, 1960, 1992; Williamson 1975) and later began to focus more explicitly on the institutions of governance and their relationship to the relative economic performance of national economies (Olson 1982; North 1990a, 1991; Acemoglu 2005; Acemoglu *et al* 2005). Coase (1937) initially proposed the idea that the neo-classical assumption of zero transaction costs led to a failure to understand the role of firms as organisational entities in the economy: some functions in the market are performed via exchange among firms and other agents, and some are internalized within the command bureaucracies of firms themselves. The firm emerges as a "governance structure" (Williamson 2005: 4) as a direct result of the functioning of the market. The emergence of these hierarchical institutions reduces transaction costs and ensures the continuity of exchange in two ways: i) adaptation to the market and the organisation of the continuity of exchange takes place via co-operative behaviour *within* firms as organisations, and ii) through ongoing contractual relationships *among* firms to reduce

uncertainty and process necessary market information "for which continuity of the relationship is a source of value" (Williamson 2005: 2).

Williamson's 'economics of governance' (2005: 1) resolves problems of interactive complexity wherein uncertainties and collective action problems are an integral part of the costs of operating in competitive markets. The emergence of governance and hierarchy is integral to maximising the rational self-interest of economic agents. This 'private ordering of the market' may be labelled as 'First Order' governance, and remains distinct from the legal order of the state, which Williamson understands to be exogenous to market exchange. Nevertheless, other forms of co-operative and/or associational behaviour *among* firms/agents also require explanation. Soft law, dispute settlement, private industry standards, and diverse forms of self-regulation are likewise observably integral to the operation of markets in which transaction costs are greater than zero.

The transaction cost principle can be extended to demonstrate that this broader range of institutionalised co-operative behaviours is also endogenous to the self-interested and rational utility-maximising preferences of agents. Williamson's logic implies that as patterns of market interaction become more complex, for example across market sectors, uncertainties and therefore the cost of maintaining the continuity of transactions under conditions of competition increase. If transaction costs are to be reduced, this provides incentives for a more sophisticated 'Second Order' of governance over time, beyond the organisational structures of firms alone. Membership remains voluntary, and these associational institutions remain essentially in the private domain, but there is a system of collective authority and (potentially) enforcement *external* to the economic agent or the firm itself, and members contribute financially to the system at the same time as they help compete to determine the way it works and in whose interest. The very reason why transaction costs lead to the

emergence of firms is the same reason that complex market systems generate institutions superior to the constituents of the market themselves.

There are numerous examples. Coase points out (1992: 718) that while economists often characterise securities exchanges as examples of perfect competition, these private institutions "regulate in great detail the activities of traders.... What can be traded, when..., the terms of settlement, are all laid down by the authorities of the exchange...in effect a private law." These quasi-legal institutions underpin the efficiency and operations of the exchange by dramatically lowering the costs of transactions, or they would not exist.[4] Private ordering often has even its own systems of soft law arbitration, even in the international domain (Dezalay and Garth 1995, 1998).

As the stock market example suggests, in Second Order governance involves co-operative and/or perhaps collusive behaviour derived from rent seeking utility functions that attenuate or otherwise shape the terms on which agents compete among themselves, as. Understanding the role of more independent, 'state-like' forms of institutions is no longer a major step because they perform many similar functions and operate in similar ways. The observable overlap between First and Second Orders implies similar continuity between the private Second Order and the domain of the state and the law: property rights, legal dispute settlement, the monetary system, or taxation to pay for collective goods. Institutional economics consistently portrays governance of the Third Order as exogenous to the market,[5] yet this 'Third Order' of governance also serves to reduce uncertainties, deal with complexity, resolve collective action problems, and thereby ensure the continuity of the market. Why should they be thought of separately if they perform analogous functions?

[4]They may also involve highly exclusionary memberships and collusive forms of market interaction, as did many stock markets prior to 'de-regulation'.

[5] Acemoglu *et al*. (2005: 451) is one rare exception.

The proposition here is that just as agents in the market invest in Second Order institutions, they also contract into the co-operative and often collusive institutions of the state. Agents face incentives to take the extra step where transaction costs are high, and the benefits of Third Order governance considerable. North (1990a, 1991) and Coase (1960, 1992) move us a step closer by explicitly acknowledging the role of formal political institutions, law and regulation and the problem of dealing with social costs. The complexity and costs of market interaction increases substantially across factor constituency divides. In order to function, the market indeed requires the establishment and enforcement of specific types of relationships across a diversity of agents (capital, consumers, labour).

Incentives may prove insufficient, so why might agents cede their autonomy to the Third Order? Second Order governance is directly controlled and organised by self-interested parties to the market and there is always a notional exit option. Second Order institutions therefore best provide private (if collective) goods. As Olson (1971) pointed out, genuinely public goods will tend to be consistently under-provided in large-scale complex settings, and free rider problems will ultimately frustrate collective provision in the absence of some form of coercion (Olson 1971, chs. 1-2). As market complexity and the dilemmas of collective action increase, Second Order institutions may prove increasingly ineffective in managing relationships in or outside their limited membership. Where partners are also rivals, defection and the associated institutional instability mean that transaction costs remain potentially high, and costly uncertainty abounds. The contractual parties will choose Second Order private solutions only as long as the conflicts of interest and associated transaction costs of resolving them remain acceptable.

Third Order forms of institutionalised governance can resolve these difficulties because vested with superior authority. Furthermore, as Krueger has already established, the political

and legal institutions of Third Order governance are *permeable* (if not perfectly so) to a range of interests, and (partial) capture is a present possibility. Policy rent seeking utility maximisers and their Second Order constituencies compete to determine the nature of collective goods provision and the terms of competition under the law, thereby influencing distributional outcomes as well. This is particularly the case when one admits that the market consists not only of firms, but also of consumers and labour representing different social constituencies. In this way social compromises reducing the conflicts of interest and transaction costs of labour and goods markets can be achieved and enforced. These institutions evolve in relation to the rival constituent interests in the market, though some constituencies are likely to prove far more influential than others. Thus the legal system and regulatory provisions of government are endogenous to the way the market functions.

1.4 The Model

The discussion so far has established that there is a clear relationship between the emergence of First, Second, and Third Order forms of governance and the problem of transaction costs and market continuity identified in institutional economics. Building on the institutional economics approaches explored above this section provides a model demonstrating the relationship between micro-level agent utility functions and macro-institutional outcomes across the three orders of governance. The discussion first explores the nature of utility maximisation, i.e. what in empirical terms agents pursue in their mutual rivalries. The section goes on to derive from agent-based behaviour the three orders of governance as endogenous to rivalry in the market.

The classical political economist Adam Smith (1937 (1776), 250) argued persuasively that business has an inherent tendency to seek to “widen the market and narrow the competition.”

The agents that economic theory associates most intimately with markets as allocative devices are those most likely to interfere with their effective functioning and overall efficiency, and this likewise applies to land or labour. *Utility-maximising behaviour under conditions of economic rivalry may prove as collusive as it is competitive.* The emergence of markets is driven by rent seeking agents whose rational utility-maximising motive detects little interest in competing openly with others if they can help it (Fligstein 2001).

As agents pursue their preferences and realise competitive and distributional advantages over their rivals in a setting of increasing market complexity, their interaction will generate patterns of governance across the three orders of governance. These institutional compromises among (policy) rent-seekers exist on a continuum from the relatively open to more or highly restrictive. Shifts along the continuum are better for some agents than for others, irrespective of the 'public good'. *Each, competition/free trade vs. regulation/protection, represents contrasting preferences of different producer groups in the economy; each is a governance solution peculiar to particular utility maximisers or constituencies thereof in specific circumstances.*

In this sense, the model demonstrates theoretically how and why the institutions of governance are necessarily *endogenous* to the functioning of the market. The argument proceeds as follows:

1. Rivalries among economic agents principally concern the terms upon which each will compete with the other, with interests focussed on maximising respective utility functions. This concerns both rivalries among sets of like economic agents (e.g. sets of firms or workers in competition with each other) and rivalries across the land-labour-capital-consumer constituency divides.

2. Rivalry among economic agents involves as much collusive as competitive behaviour, with rent seeking both endemic and, for particular agents, often enough more utility-maximising than open competition. In this sense, rivalry among agents does not always lead to open competition, and collusion-based co-operative processes are one way to resolve a range of transaction cost problems ranging from continuity of

exchange in the market, to the provision of the collective and public goods which resolve collective action problems, and controlling free rider behaviour.

3. Forms of organisation and associational behaviours emerge as a result, beginning with the emergence of the firm. These institutions may be classified as First, Second, and Third order governance and emerge in relation to the (rising) level of transaction costs and the complexity of market interaction. These patterns of governance both resolve conflicts and facilitate co-operation, though they may involve aggregate-level costs. Contrasting forms of market and institutional development correspond to political-institutional compromises based on the preferences of interacting agents.

4. Logically, this means that the terms of competition are affected not only by the competitive deployment of 'economic' resources in the market, but also (and sometimes principally) through the (institutionalised) deployment of political resources in line with agent preferences. This provides a further incentive for ongoing investment in the institutions of governance in a situation of economic competition. Economic agents are involved in the simultaneous deployment of both political and economic resources, which means that there is a fundamental unity between political and economic aspects of rivalry among agents.

5. Preferences depend upon the sort of agent, their resulting perceived self-interest expressed as a utility function, and their real economic and political resources and position in the broader market for production and distribution. These preferences are a function of the (institutionalised but potentially dynamic) position of agents in the market, of their corresponding capacities simultaneously to deploy a range of economic and institutional power resources, and (eventually) of institutionalised patterns of behaviour by vested interests.

6. What is efficient for some is not always for others, and preferences coexist on a continuum between open competition and collusion, with neither pole ever being reached in the real-world. Each point on the competition/free trade–regulation/protection continuum represents a governance solution for particular constituent interests in specific circumstances. The institutionalisation of first-mover preferences and the phenomenon of path dependency makes it highly likely that a 'bad equilibrium' producing poor economic outcomes may persist for some time.

7. This model hypothesises reflexively that the dynamics of competition in the market generate both the economic strategies of actors and their preferences concerning regulation and governance, and that the outcome of conflict over divergent actor preferences concerning governance and regulation in turn generates changes in market structures. Changes in preferences concerning governance therefore are intimately bound up with changes in and preferences concerning market structure. The distinction between the economic domain of 'markets' and the domain of governance inhabited by the state and government breaks down, and should be replaced by the notion of a *state-market condominium*.

8. In practical terms, while real-world outcomes may well be measured as more or less efficient in relation to theoretical norms, 'efficiency' in this sense is no less abstract than the ideal of perfect competition. Following Acemoglu *et al* (2005, 451) but taking the point both further and more seriously, issues of efficiency and distribution are "inseparable": if what is efficient for some may not be for others, then efficiency should be understood in *relative* terms. Policy-makers will need to engage in normative choices as to whose version of efficiency should prevail, and to maximise the range of constituencies for which particular solutions are seen as efficient. This is a central task of Third Order governance. Establishing (relatively) open systems of competition-based rivalry may be one solution to this 'public interest' problem.

This article now goes on to illustrate the model in relation to the liberalisation and eventual collapse of the global financial order.

2. Model Applied: Cross-Border Markets, Market-based Governance, and Financial Crisis

The model makes a number of predictions concerning the evolution of the financial system and its governance, derived from the general proposition that a diversity of institutions of financial governance and supervision are endogenous to different forms of markets functioning along a continuum from (relative) financial repression to (relative) financial openness. The first is that the perceived competitive position of particular agents in the market at t_1 will largely determine their preferences in relation to the terms of competition: taking a particular agent's norms as given, their perception of their own competitive resources specifies what sort of market on the openness-financial repression continuum they prefer, and thus their preferred governance framework as well. Preferences concerning the terms of competition are integral to the capacity of agents to deploy competitive resources against their rivals in the market. The second is that institutionalised policy rent seeking will be a prevalent aspect of the pursuit of utility-maximisation by agents in financial markets: financial firms and other agents will seek a regulatory framework and terms of competition

that suit their utility functions wherein the latter combines both collusive and competitive tendencies. Firms and other economic agents will seek to capture both Second and Third Order governance processes, symbiotically shaping the terms of competition to their own advantage through the deployment of economic resources against rivals and of political resources through the institutions of governance. Thirdly, there will be a non-linear but systematic relationship between shifts in the structural dynamics of the market and shifts in agent preferences for institutions and governance: as the dynamics of market competition change over time, agent preferences in terms of governance will shift and they will respond in turn by seeking regulatory and other changes. In short the system is reflexive: conflict over the terms of competition in the market at t_1 generates changes in actor preferences concerning regulation and governance, and that the outcome at t_2 of conflict over divergent actor preferences concerning governance and regulation generates changes in market structures at t_3, and so on. Finally, this model also predicts that there is no guarantee that the utility-maximising behaviour of agents and their shifting preferences over time will result in institutions that promote a high degree of economic efficiency, nor that market equilibrium and therefore stability will prevail. On the contrary, policy rent seeking in Second the Third order institutions simultaneous to market competition with rivals may well result in financial institutions appropriating to themselves advantages in the terms of competition that contribute little to financial stability and push the potential costs of risks onto other agents or collective institutions in the economy. Material gain may be sought in ways that undermine systemic stability.

This section demonstrates that the past thirty years of cross-border financial integration and its descent into financial crisis corresponds to the model. The most competitive firms and financial authorities pursued a policy rent seeking programme of financial liberalisation, dismantling much of the post-war system of financial repression that provided financial

stability while restricting competition. As episodes of financial instability accompanied the process of liberalisation, public and private agents embedded in the new financial order sought to strengthen the system of governance in ways that were compatible with their preference for open markets. The resulting market-based system of governance rewarded the policy rent-seekers with competitive cost advantages, yet contributed directly to the financial collapse of 2007-08.

2.1 Cross-border financial integration

The starting point of the applied argument is the transformation of the financially-repressed but stable post-war order into a highly integrated, cross-border and market-based system. In contrast to arguments in much of the literature (e.g. Abiad and Mody 2005), political processes and decision-making initiated and gave form to the emerging liberal and transnationally-integrated financial and monetary order (Helleiner 1994; Burgoon *et al* 2008). Behind this change there agents in the main financial centres of the US and the UK: elite state agencies managing mounting public debt and private financial institutions impatient with the constraints of saturated markets. Both saw potential benefits from a more market-based order (although national financial sectors were frequently highly divided on the issue). The ex-ante market structure shaped their preferences in favour of regulatory and other policy changes to pursue their goal of greater levels of openness and of integration across the sub-sectors of the financial system.

A key and early event in the process which accelerated shifts in the preferences of key players was the failure of the Bretton Woods fixed exchange rate system in 1971. This led to an explosion of international financial market activity around the floating foreign exchange market and the financing requirements of growing payments imbalances and government

fiscal deficits of the 1970s and early 1980s. Both national treasuries and central banks, as well as the private institutions that issued and auctioned bonds and a range of new instruments for public and private agents alike, were actively seeking financial innovation and new, global opportunities to respond to rapidly-emerging and often urgent need. This became an emerging alliance, based on shared but not identical interests, between public and private market players in a sector where relationships in the markets and regulatory and supervisory policy-making process had always been close. As Helleiner argues convincingly (1994) states were thus crucial and complicitous players in alliance with the most powerful organised private constituencies in financial policy-making.

The first phase therefore began with US and UK regulatory liberalisation both domestically and at the border and the associated end to exchange and capital controls and other forms of macro-economic governance of the Bretton Woods era. The EU internal market liberalization which came with the '1992' Single Market Programme (SMP) was also a key event. A broad, largely transatlantic and cross-national coalition seeking a more liberal international financial order had emerged and successfully achieved its aims in a range of key financial centres simultaneously (Moran 1991), developing a system characterised by a high degree of capital mobility and cross-border/-sectoral financial integration.

By the 1990s the financial and monetary landscape had been transformed beyond recognition. The benefits were considerable, especially for those who were part of the most competitive financial firms or centres, including national treasuries and central banks. The latter benefited substantially from the widespread movement toward central bank independence, enlarging their room for manoeuvre. Yet there were also costs in terms of the series of policy dilemmas known as the 'Unholy Trinity' (Cohen 1996) for macro-economic policy, with which governments slowly learned to cope. National regulation and supervision

were rendered much less effective by cross-border integration. Financial crises became considerably more frequent (Bordo *et al* 2001), and it is often forgotten just how many developed countries went through banking crises following the financial liberalization of the 1980. Volatile capital flows broke the European exchange rate system 1992, but the emerging market cascade began at the end of 1994. The 'peso crisis' in Mexico spread to Brazil and elsewhere, then there was the widespread Asian crisis of 1997-98, the Russian default of 1998, the LTCM debacle, Argentina and Turkey in 2000-2, and now the sub-prime crisis the denouement of which remains uncertain. Serial instability generated new preferences for multi-level institution-building to enhance global financial and monetary governance, albeit on a 'governance-light' market-based model.

2.2 Emerging Market-based Governance

The interest of the broad liberalising constituency in innovation and market opening is intuitively understandable, but the demand for the restrictions of enhanced governance less so, and the concurrence of public policy with private preferences in such a crucial policy domain still less. Yet the model predicts that even as economic agents compete with each other in the market, they may collude and/or deploy political resources the better to shape the terms of competition to their own advantage, along the way establishing path-dependent institutions of governance in which their interests are embedded.

The new integrated market environment carried with it the costly problem of increased risk and new transmission mechanisms leading to potential market collapse. Increasing market complexity and rising transaction costs may shift preferences in terms of governance. The same policy rent seeking constituencies that sought liberalisation thus developed new preferences for collective and enforceable solutions to reduce these costs and to appropriate

public resources to underwrite the system. Agents chose simultaneously for open markets and enhanced if limited multi-level governance. Over time, this new financial architecture (consisting of both Second the Third-Order institutions) developed a close correspondence between the preferences of the most globally-active elements of the private sector and the policies which were implemented by public authorities. The emerging system of financial governance awarded competitive cost advantages to this same public-private alliance while the mantle of public policy permitted the further proliferation of new and profitable forms of risk-taking and leverage through product innovation.

The new system of governance ultimately transferred the risk to the public sphere in a system notionally built on the intellectual foundations of contemporary financial economics taught widely in business schools and practiced by many of their graduates. Market forces and self-supervision replaced public intervention and on-site supervision in the prudential management of the financial system. At the heart of what was supposed to be a public-interest bulwark against financial instability and crisis stood a coalition of interests, a state-market condominium, which pursued its preferences in terms of private gain through the system of governance.

Public authorities were clearly complicitous yet this was no grand conspiracy. The key state agencies were also market players like any others: states are among other things financial conglomerates with their own marketable assets (the currency, loans, treasury notes), their own (central) banks to manage their affairs in the market, and a series of functions requiring large revenues and the management of debt. The emergence of 'governance light' involved a slow convergence of public and private interests in the key financial systems and of the development of shared market-based policy solutions by public and private agents with a range of overlapping interests. Furthermore, the very act of strengthening global financial

supervision and regulation helped underwrite the risks to private business of further liberalization, reassuring the general public on the way. This trend can now be examined in relation to the model with direct reference to the example of international banking supervision.

2.3 Market, governance, and international banking supervision

Capture is said to prevail when the articulated preferences of a particular and relatively narrow interest-based constituency can be observed consistently and systematically to correspond to outcomes in terms of policy and to the notable exclusion of the preferences and needs other interested constituencies. In other words, capture prevails when the 'regulated' effectively use public institutions to set the regulatory policy agenda and outcomes for themselves: a narrow range of private interests successfully dominate and appropriate for themselves the mantle of the public interest. To demonstrate conditions approximating capture, it must be shown that over time a relatively narrow constituency successfully and consistently permeated the policy community, and that either a) despite conflict and alternative proposals these narrow interests prevailed or b) the process operated so as to produce an outcome which effectively excluded the articulation of alternative constituency preferences in terms market structure and governance. Policy rent seeking succeeds best when successfully converted to policy capture based on shared preferences and ideas.

The latter took place in the emerging system of international banking supervision centred on the Basel Committee for Banking Supervision (BC) responsible for international agreements on the supervision of international banking conglomerates and the Basel II accord debated from 1998-2006. The centrepiece of the BC's achievements in the 1980s was the capital adequacy accord of 1988, which had standardised the traditional approach to capital

adequacy of bank supervisors to internationally active banks. Rapid change in the sector, particularly the trend towards the securitization of lending practices and the rise to prominence of the capital market activities of banking institutions, undermined the effectiveness of the agreement. Most of the large and once essentially nationally-based (commercial) banks became highly internationalised 'universal banking' financial conglomerates owning capital market subsidiaries, (unregulated and often off-shore) derivatives investment vehicles and other sorts of securities-oriented subsidiaries, as well as insurance companies across the developed and developing world.

Banking supervision and risk management practices had to be adapted to the new capital-market and off-balance sheet orientation and conglomerate structure of financial institutions and the new, globally-integrated setting. There was already a strong lobby from the banking industry to replace the 1988 agreement with a new approach to risk management and supervision advocated by the Institute for International Finance[6] (IIF 1993), and supervisors admitted to having few answers of their own (Underhill 1997, 36-7). The BC responded with a 1996 amendment to the 1988 accord to cover the capital market activities of banks (BC 1996). This was the first step in the global endorsement of the 'market-based approach' to prudential supervision and capital adequacy, an approach proposed by the very private sector it was supposed to regulate.

The new approach had the signal feature of permitting large banking institutions to hold less capital on their securities market/investment banking operations, as long as internal risk management portfolio hedging systems were approved by the supervisor. Only the most 'sophisticated' financial institutions were in a position to benefit from the measures in this

[6] The IIF is the main association of international banking institutions, originally formed as a consultative group of major US and European banks during the debt crisis of the 1980s, and became a more broadly based organisation representing some 350 member banks worldwide. See website for membership, http://www.iif.com/about/ member_list.quagga.

way, and one might note that these were largely the very financial institutions that were to bring down the entire edifice of global finance in 2007-08. The economic argument in support of the approach was drawn from financial economics: market forces would play a positive and indeed central role in the containment of risks taken on by individual financial institutions. The approach was also in line with the prescriptions of portfolio theory requiring internal risk management based on state-of the art value-at-risk (VaR) models; market 'transparency' based on a greater degree of corporate disclosure concerning the risk profile of an institutions; and reformed 'mark-to-market' price-based accounting practices long familiar to the US securities sector. The clear assumption was that financial institutions best understood the nature of the dynamic risks they took on, and the pressures of market competition meant that they faced the strongest incentives to avoid the difficulties of unnecessary risk-taking: failure would be the ultimate sanction.[7]

Following the successful translation of private sector preferences into BC policy, the IIF–BC relationship became more formalized in practice. There was soon a lobby to extend the market-based approach to the supervision of credit risk as well, thereby covering the investment and commercial banking aspects of the financial conglomerates. Once again, the proposals came from the IIF (1998) and the approach was initially pushed by the influential think-tank the Group of Thirty (G30 1997).[8] After a long debate, the market-based approach to supervision was extended to international credit markets (BC 2006a). Once again, the industry and its Second Order private associations played a key role in developing and advancing the reform proposals themselves and the accord reshaped the terms of competition in international financial markets in favour of those very interests that had advocated the new

[7] Which assumed that moral hazard and 'too big to fail' would not play an undue role in the picture.

[8] The G30 is a think-tank-like institution whose thirty members constitute a 'Who's Who' of the world of public and private finance. The group identifies key policy issues in global finance and produces influential reports advocating specific policy solutions and reforms. The report cited includes the names of study group participants (pp. ix–x), and members of the G30 itself (pp. 47–48).

approach. Claessens *et al* (2008, 322-7) argue persuasively that there was a clear pattern of winners and losers under the new system that awarded advantages to the most competitive (and systemically significant) financial institutions able to employ the new 'advanced' system of self-supervision. Indeed according to the BC's *own* estimates,[9] this 'advanced approach' would tend to lower the regulatory capital of banks employing it and reduce the cost of their lending operations relative to their smaller brethren restricted to the 'standard' approach. Banks (and their clients) using the latter would find their capital reserves more likely to rise, thereby hurting their competitive position, even though an eventual failure of these smaller institutions was unlikely constitute a risk to the financial system as a whole.

The principal merit of the new accord was that it improved the competitive position of those large financial institutions that had proposed it. Although the new accord broadened the range of risks covered by the BC supervisors and advertised a range of other benefits, the biggest problem was that it was unlikely to work. There was at the time plenty of criticism of the approach (Claessens *et al*, 326-7), particularly of the 'aggregation problem' and the issue of market 'procyclicality' but these were either ignored or only taken into account to a limited degree by the BC. In short, good risk management by a range of individual banks might not add up to a sound financial system, and the inbuilt market incentives might mean that supervisory practice could accentuate financial cycles and indeed herd behaviour in the market. "Market prices should never be employed as a solution to the problem of market failure," warned Avinash Persaud (2000), head of State Street Bank and winner of the IIF international finance essay competition in 2000. Instead, any system of prudential supervision should be *counter*-cyclical, attenuating the market trends which might constitute a bubble and stemming the tide of panic in a downturn, or "leaning against the wind" (Goodhart and Persaud 2008). Warnings there were but the proposals remained largely intact at the

[9] BC 2006, pp. 5–11 and table 5.

point of implementation. The crisis tells us that the system either did not or perhaps could not work. This is in line with the predictions of policy rent seeking and the potential for policy capture under conditions of liberalisation predicated on the model.

3. Conclusion: Financial Governance and the State-Market Condominium

The financial collapse of 2007-08 rang many alarm bells simultaneously in relation to public policy, the conduct of private financial institutions, and our understanding of financial market stability and regulation in economic theory. The crisis exposed problems with how we run our financial system, and these are linked to how we think about it: in particular, to the ways in which specific forms of economic theory informed our understanding of markets and their eventual stability. Contemporary financial economics provided an alibi for a market-based system of financial supervision that failed. This paper poses the question: in what ways should we inform the teaching of economics and management differently in order to prevent such occurrences in the future? This paper has argued that the reassessment of economic theory should develop a better understanding of the intersection of economic rationality with that of governance such that the two can be understood as part of a whole. For too long, political logic was considered to pull one way, and economic logic another in a sort of state-market dichotomy or tug-of-war. If however the real-world state and the market are found to function together as an ensemble of governance, then that is the world we should analyse and theory should reflect this.

The analysis of the transaction cost literature and its application to the institutions of governance encourages a ‘last step’ in institutional economics concerning the relationship between legal and policy-making institutions and the ‘market’, demonstrating that the emergence of the institutions of financial governance is endogenous to the utility-maximising

behaviour of competing economic agents. The preferences inherent in the utility functions of market agents, firms for the most part, generate both the formal and informal institutions and processes of financial governance. The model proposed in this article helps us to understand that governance and its politics is part and parcel of how the structures of the market emerge and operate, and that the crisis was generated through policy rent seeking behaviour inherent to the utility functions of economic agents in the financial sector seeking to shape the competitive environment in their own interest. Furthermore, we should expect these rent seeking impulses to shape both the markets and its governance in the future.

If this is so, then flaws in this governance and in the *processes* through which decisions are generated should be the focus of reform as much as is the content of policy. Sub-optimal market regimes are anchored in patterns of institutionalised policy rent seeking which underpin the institutions and outcomes of the market, and they can extend into the international domain. The problem is a political one of path-dependent institutions of governance which confer political resource advantages on embedded constituencies, including specific elite agencies of state. Private power too often assumes the mantle of governance in the public interest. If the political blockage is to be removed, then negotiating strategies need to focus on either dismantling these constituencies and/or re-organising the way in which the Third Order institutions are configured. This means broadening the financial policy-making process to embrace the range of stakeholders and interests affected by its outcomes, the same broad range of stakeholders outside the current financial policy community who ultimately guarantee the risks and bear the costs of systemic failure.

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