

## REGEM Analysis 1

# Capital Market Reforms as an Economic and Political Process

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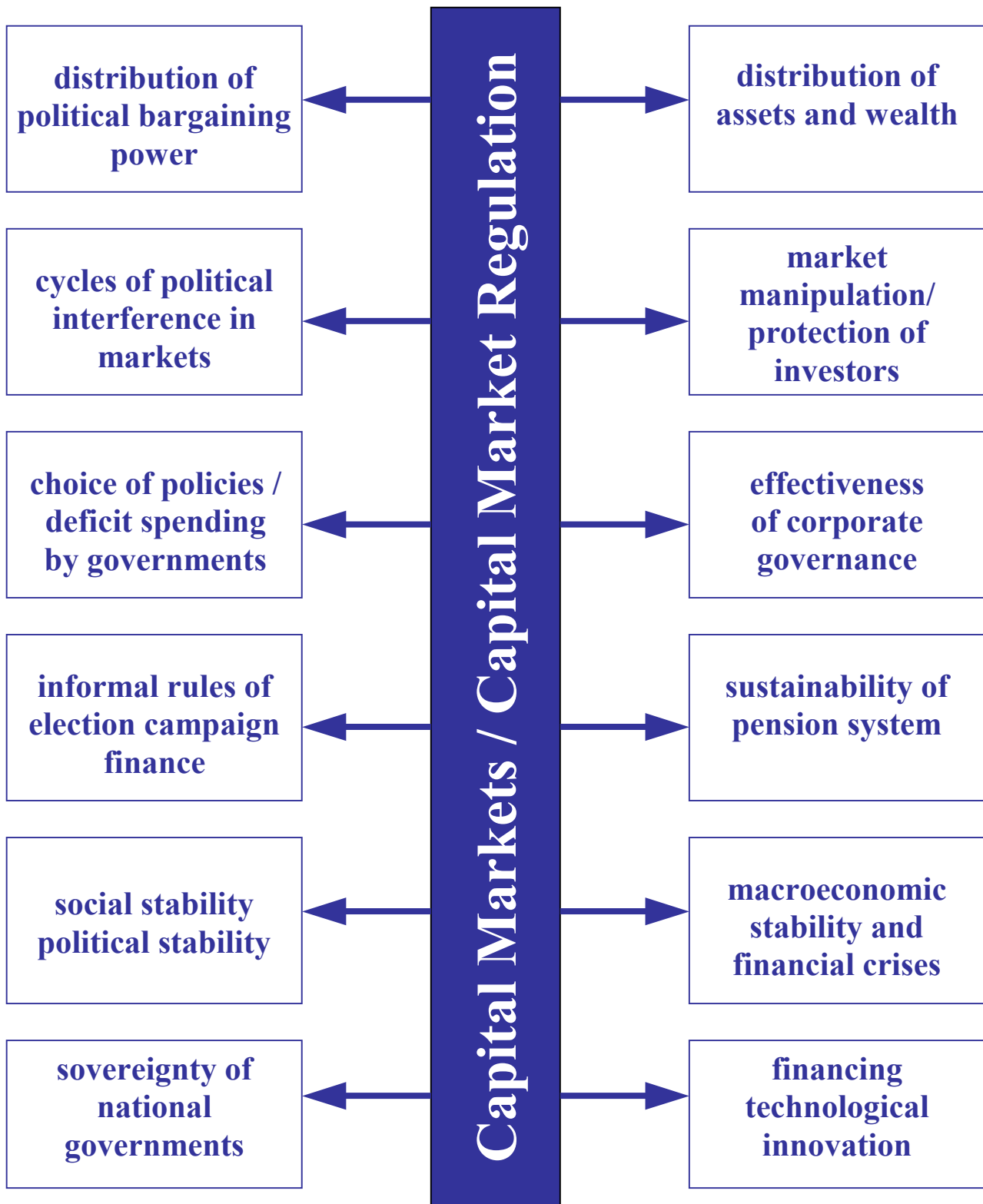
## 1 Capital Markets: The “Central Nervous System” of Modern Political Economies

Confronted with the dynamics of global capital markets, national governments and intergovernmental institutions face new tasks. Promoting capital inflows has become a key objective of national economic policy. In view of an accelerating change of technologies, products and trading systems, national governments are presently undertaking considerable efforts at reorganizing the regulation of capital markets. Simultaneously, transnational and international regulatory cooperation is also passing through a period of fundamental reorganization.

The Research Group on Equity Market Regulation (REGEM) starts from the assumption that capital market reforms cannot simply be interpreted as driven by the search for higher allocative efficiency and technological / organizational innovation. Capital market reforms must also be understood as the outcome of political negotiations and interest group activity: as the result of a political process that produces new institutions and is driven by the interplay of national regulation, transnational economic actors, intergovernmental regulatory cooperation and global capital markets. REGEM will examine these interrelations by studying the national, transnational and intergovernmental dynamics of equity market regulation.

In a metaphoric sense, capital markets can be conceived as the “central nervous system” of modern political economies since many vital functions of modern political and economic systems are strongly affected by the workings of capital markets (see chart). Capital markets and their regulation have immediate effects not only on macroeconomic stability, asset distribution and key economic institutions (such as corporate governance, pension systems and investors’ protection) (see right side of chart). Capital markets also have a direct impact on the workings of the political system (left side of chart).

# Capital Markets as the “Central Nervous System” of Modern Political Economies



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How strong the influence of capital markets on *political systems* can be, became manifest with the Asian Financial Crisis (1997-1999) and the Wall Street credibility crisis that was triggered by the Enron affair in autumn 2001. It was demonstrated by these events that the development and the rules of the game in capital markets impact on key political variables with an intensity that was largely underrated before:

- the distribution of political bargaining power (pressure group capacities),
- the extension of political interference in markets (cycles of scandal-driven, strict re-regulation, subsequent gradual relaxation of enforcement, leading again to scandals, re-regulation etc.),
- the choice of policies and deficit spending by governments (rating of government creditworthiness by capital market participants) which in turn affects the range of sovereign decision-making power of national governments,
- the acquisition and informal rules of election campaign finance (cf. the role of Wall Street companies as campaign sponsors) and
- overall social and political stability (as made clear by the recent Asian and Latin American Currency Crises).

## **2 Research Innovation: Integrated Analysis of Economic and Political, National and Transnational Processes**

What is new about the approach of this research group? The analysis of equity market regulation requires an integrated perspective which simultaneously takes economic *and* political factors into account. In order to achieve this, new approaches of institutional research in the fields of economics and political science (New Institutional Economics, Public Choice, Neoinstitutionalism, with a special emphasis on theories of regulation) shall be applied with the aim of practicing an integrated "real" political economy that Douglass North (Nobel prize winner for economics) has repeatedly encouraged.

Moreover, the separation between comparative government (domestic political affairs) on the one hand and international relations (international political affairs) on the other hand that is still prevailing in political science shall be transcended so as to broaden research perspectives beyond conventional disciplinary boundaries. The political economy of equity market regulation must be examined by equally taking the national, transnational and interstate dimensions into account.

By now, research on equity market regulation usually concentrates on the analysis of either international capital market trends or single national markets and their regulatory systems. Generalizations that are derived from such a restricted research perspective shall be examined critically in the course of REGEM's work. With our peculiar research perspective, we want to contribute to a deeper, empirically sound understanding of the interactions between politics in nation states, transnational market participants, intergovernmental cooperation and global markets.

Our research can draw upon important recent contributions to studies of financial regulation and the politics of finance by scholars such as Stephan Haggard, Geoffrey Underhill, Tony Porter, Ethan Kapstein, Susanne Lütz, Michael Moran, William Coleman, Sylvia Maxfield, Thomas Oatley, Barry Eichengreen, Wolfgang Reinicke, Steven Vogel, Philip Wellons and Leslie Armijo.

The research group has already done considerable groundwork by dealing with the political economy of the Greater China economic area, particularly with issues of economic reform policy and equity market regulation. The field of research has recently been extended to issues which transcend the Asia Pacific region.

### 3 Research Questions

The following guiding questions serve as a basic orientation for the comparative case studies which are carried out by members of REGEM:

- ▶ **Economic and political factors that shape regulatory change:** Actually how important are criteria of market efficiency and systemic risk minimization in the process of establishing capital market rules? How important is political bargaining strength in this process? Can key regulatory issues (such as rules of information disclosure or legal liability) be understood as mere technical and unpolitical issues? What particular interests prevail in the liberalization, modification, supervision and enforcement of equity market regulation?
- ▶ **The role of transnational capital market participants:** How do national politico-administrative actors and transnational investment banks and broker houses interact? Can we name market participants who act as agents of globalization in the regulation of capital markets? How do such agents proceed in the reorganization of national regulatory regimes? Can we conceive of large banks, broker houses or insurance companies as coherent units of action that push forward unified interests globally? Is there evidence that usually competing market participants may constitute a uniform pressure group with the aim of revising capital market regulation?
- ▶ **Impact on national governments and democratic institutions:** How is the relationship between public-sector and private-sector protagonists in the national, transnational and international contexts changing? What kind of impact does the globalization of capital markets have on key features of nation states such as national sovereignty, political supervision of financial markets, democratic control and responsible government? How do different governmental systems respond to the challenges? How much leeway is left for national regulation?
- ▶ **Privatization of market regulation:** How important is the divergent bargaining power among public-sector and private-sector protagonists involved in the rearrangement of market rules? To what extent is the regulation and supervision of capital markets already privatized and dominated by market participants or public-sector market "insiders"? Are these market participants still subject to effective political restrictions and controls? Can we find empirical evidence for the capture of regulatory bodies by market participants ("regulatory capture") in national, transnational and intergovernmental regulatory systems?
- ▶ **Peculiarities of transnational cooperation in the realm of capital market regulation:** Can we identify organizational or personnel networks among regulators in the national and transnational context? Are there policy/regulatory networks, "epistemic communities" or professional "clubs" that exert a decisive influence on transnational cooperation?
- ▶ **Relationship between "regulatory lead markets" and "emerging markets":** What kind of dependences or participatory opportunities exist for political and economic actors from "emerging markets" or "frontier markets"? How strong is the international influence exerted by the U.S. model of capital market regulation in reality? Which protagonists with what particular interests promote the global dissemination of the U.S. model? What kind of criticism and resistance is restricting the dissemination of the U.S. model in other political economies? Are there other regulatory models that exert broad influence without being in the foreground of the present debate?
- ▶ **Institutional convergence:** In which direction does the regulatory competition between national governments move in the realm of capital markets? Is there really a trend towards global institutional convergence?

## 4 Fields of Research and Case Studies

We will deal with three central fields of research. Research will be based on common guiding questions, systematic categories and research approaches.

### 4.1 Market Reforms and State Regulation in Asian and Pacific Economies

The research group intensively studies capital market reforms in Asian and Pacific economies, due to the regional focus of Professor Heilmann's chair and due to the weight of the region in global capital markets that was manifested by the "Asian Financial Crisis". Studies of equity market regulation and the politics of finance in the People's Republic of China, Taiwan and Hong Kong have already been completed.

### 4.2 Institutional Reforms in "Regulatory Lead Economies"

Simultaneously, institutional developments and reform processes will be analyzed in a broader comparative study of global key markets: the politics of capital market reforms in the US, the UK, Japan and the European Union. These "lead economies" are the starting points for innovations of trading systems and market products and serve as the basis for the financial strength and political bargaining power of transnational capital market actors. Several studies of these markets are in full progress (see 5 below).

### 4.3 Transnational and International Institutions of Capital Market Regulation

Changes of national regulatory systems cannot be properly comprehended without a deeper knowledge of transnational and intergovernmental regulatory cooperation. Therefore individual members of the research group will intensively study the role of the International Organization of Securities Commissions (IOSCO) and the Basle Committee on Banking Supervision (BCBS) and will try to find out more about the establishment, rules of the game and influence of transnational regulatory networks. Studies of these topics are in preparation.

## 5 Research Results

5.1 For completed studies use the link <http://www.regem.org/>

### 5.2 Studies presently in the making:

- International Approaches to Combating Money Laundering
- The Financial Services Authority in the UK: A Model for Unified Capital Market Supervision?
- The Enron Scandal, Wall Street and Capital Market Supervision in the US
- Capital market regulation in Luxembourg: Institutions and Actors
- Capital Market Reforms in France: By European or Special French Standards?
- Interest Group Activity and Capital Market Reforms in Germany
- The Japanese Banking Crisis: Political Causes and Political Reform Constraints
- Reforms and Institutions of Capital Market Supervision in Japan
- Regulating the European Capital Market: The Role of ESC und CESR
- Regulating International Capital Markets: The Role of IOSCO
- Regulating International Capital Markets: The Role of the Basle Committee
- „Basle II“ Negotiations“: Interest Articulation and Negotiation Strategies of German Participants
- Privatized Regulation on Financial Markets: The Role of Rating Agencies

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