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Widen the market, narrow the competition : the emergence of supranational governance in EU capital markets

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CHAPTER 1: INTRODUCTION

EU capital markets have changed fundamentally over the past two decades. Alongside the introduction of the euro, the market for financial services has been integrated on a European level.¹ Banks and investment banks that provide investment and capital market services now enjoy cross-border access, while a European industry has emerged centred on the City of London. Rule-setting has also been integrated across borders. Most regulation affecting capital markets now has an EU scope and is decided through EU institutions, while new bodies have been created at the supranational level. In short, the governance of capital markets in Europe—the rules themselves as well as policy-making institutions—have been supranationalized.

The novelty of this supranationalization lies in its supplanting of national governance. In doing so, supranational governance calls into question the viability of national ‘varieties of capitalism’ and the socio-economic compromises that they have traditionally sustained. National financial market policy has always been formulated within an international context, just as domestic financial markets have always been embedded in global financial markets. Until recently, however, financial market governance could be divided into domestic and international components—into a domestic policy process and national laws on the one hand, and international bargaining and agreements on the other. Domestic and international politics thus fit the image of two-level games (Putnam 1988) with governments acting as the transmission belts between them.

This division between the domestic and the international levels in the governance of European capital markets no longer holds true. Few facets of capital markets today remain untouched by EU rules. While global economic developments clearly contributed to regional integration and the concomitant reform of national models of capitalism (Glyn 2006),

¹ In EU policy debates, public officials and private actors use a number of labels for this segment of financial markets interchangeably. ‘Investment services’ is most accurate but technical. ‘Securities markets’ is also used, while ‘capital markets’ is most common. For reasons of accessibility ‘capital markets’ will be used in this text unless the need for further accuracy requires one of the other two.

globalization in and of itself did not spell the end of national diversity or pre-determine regional integration (Schmidt 2002). The supranationalization and harmonisation of capital market governance has been a question of choice, not of economic necessity.

The main question this thesis seeks to answer is what explains that political choice. At stake in such a question is not just the genesis of supranationalization, but also the broader interaction between the political and the economic domains. As a discipline, political economy has traditionally explored the relationship between patterns of governance and market structures and how changes in one may trigger shifts in the other (Underhill 2006). The relationship is far from straightforward, however, and remains poorly understood—as is the supranationalization of EU capital markets as a case study of how ‘markets’ and ‘politics’ interact. In particular, some important exceptions to the contrary, much political economy literature remains insensitive to the mutual constitution of markets and their governance. Approaches to European integration such as neoliberal intergovernmentalism and neofunctionalism tend to underestimate the ‘material’ foundations of (changes in) governance, just as theories that aim to explain financial liberalization underrate and misunderstand the ‘political’ foundations of changing market structures.

This thesis aims to redress such shortcomings, thereby revealing the political-economic roots of EU supranational integration, and in turn contributing to the further understanding of how political governance and market structures interact. Four findings stand out regarding the emergence of supranational capital market governance. First, the politics of capital market integration have been dominated by a small group of political insiders; the preferences of financial firms have ultimately been responsible for the scope and timing of integration. Second, firms’ political preferences were inspired by the impact of regulation and governance on the terms of competition between them, rather than, for example, profits. Third, supranational integration can only be understood by viewing both how agents create structures (collectively binding rules, political institutions and markets) and how these structures simultaneously shape agents’ preferences. Fourth, such ‘structuration’ yields a political economy dynamic wherein

outcomes remain open-ended and are fraught with unintended consequences and thus inner contradictions.

This introductory chapter is structured as follows: first it lays out the central questions guiding the thesis and gives an overview of the empirical case at its heart. It moves on to expose the shortcomings of existing scholarly approaches to European integration and financial liberalization and sketches an alternative analytical framework. It then lays out the core argument of this thesis and highlights its societal and academic relevance. The last two sections discuss the methodological considerations underpinning this research and give a brief overview of the remaining chapters.

Central questions of the thesis

The supranationalization of governance is a radical departure that stands in stark contrast to the more restrictive, essentially nation state-based regime of the early 1990s. This thesis uses this shift to address the general following question:

- ❖ How can we best understand changes in patterns of governance in relation to shifting market structures?

Applied to the case at hand, this question can be reformulated as follows:

- ❖ What best explains the supranationalization of EU capital market governance?

This question can then be broken down into three further sub-questions:

- ❖ Whose preferences have dominated these emerging forms of EU capital market governance?
- ❖ What explains these actors' preferences, their cross-border variation and changes over time?
- ❖ What explains the pre-eminence of these actors rather than others?

The European Commission deserves particular attention. Some scholars have argued that the Commission is the engine behind integration in EU capital markets (Gottwald 2005, Posner 2005). In more general terms, the argument that the Commission and other supranational actors can influence the integration process (Nugent 1995, Pollack 1998) conflicts with a position that

still accords member states full control (Moravcsik 1998). This debate generates two final questions:

- ❖ What roles have the European Commission and other supranational actors played in the supranationalization of EU capital market governance?
- ❖ And how autonomous have the Commission and other supranational actors been in exerting their agency?

Delimiting the case: the supranationalization of EU capital market governance

The supranationalization of EU capital market governance lends itself well to an exploration of wider state-market dynamics. Both European financial markets and the political institutions through which they are governed have changed significantly over the past two decades. The case thus serves as a laboratory for analysing political economy dynamics ‘in action’. Given the multi-level nature of EU governance in this domain, this study analyzes public-private interactions spanning the national (with an emphasis on France, Germany and the UK) and the supranational levels.

The integration of financial markets was prominent among the European Commission’s arguments stressing the virtues of a single European market in the 1980s. Financial services were relevant not only as services, but also due to their impact on capital flows and investment throughout the European Union. The ease with which capital would flow across borders, went the argument, depended on the price of cross-border financial services compared to domestic ones. Cross-border stock market investment, for example, would only become attractive once its costs would approximate those for domestic investment. As the European Commission put it,

[t]he integration of financial markets across community borders is uniquely important, however, in the sense that it will not only have important effects on the efficiency of the sector itself but also on the efficiency of resource allocation of sectors using financial markets.
(European Commission 1988: 86)

The same issue of *European Economy* cited the Price-Waterhouse study commissioned by the Commission to examine financial services. It found that the macro-economic effects of

integrating the market for financial services (1.5 per cent increase in Community GDP) would be more than double the direct effects of lower prices for such services (0.7 per cent) (Ibid.: 161).

The main justification for an integrated market in financial *services* has been greater efficiency in capital markets and, as a result, higher economic growth. With most exchange controls removed around 1990, integrating markets for financial services became synonymous with integrating European financial markets in general—not least in the jargon used in EU policy-making circles. By analogy, integrating markets for investment services became interchangeable with the integration of capital markets as a whole, a convention that this study follows unless the distinction between the two is relevant.

Member states agreed on common rules for investment services with great difficulty (Brown 1997). The Investment Services Directive (ISD) was adopted in 1993 and scheduled for implementation in 1996, four years after the single market was supposed to take effect. Even by 1998, implementation lagged behind (Wymeersch 1998). ISD negotiations were further complicated by being bundled with the Capital Adequacy Directive.

Three member states—the United Kingdom, Germany and France—dominated the negotiations (Steil 1993, Story and Walter 1997, Underhill 1997). The agreement EU governments eventually reached ensured that they would retain control of European financial regulation. A minimal consensus was the result. Officially, the single market was to be achieved through ‘mutual recognition’. Regulators would exempt firms regulated in other EU member states (the ‘home country’) from compliance with regulations in the ‘host country’. Banks with headquarters in any member state would be given a ‘single passport’ granting EU-wide market access.

The scheme was never implemented. Article 11 of the ISD, which undermined the whole principle, stated:

Member States shall draw up rules of conduct which investment firms shall observe at all times. [...] Without prejudice to any decisions to be taken in the context of the harmonization of the rules of conduct, their

implementation and the supervision of compliance with them shall remain the responsibility of the Member State in which a service is provided.²

Article 11 let member states decide when local rules would need to be applied. Some member states, such as Italy, required foreign firms to set up separately capitalized subsidiaries if they wanted to offer services in their jurisdictions (Colvill 1995). In short, host authorities largely remained in charge of their markets (McCahery 1997, Levitt and Lord 2000: 175-184). The ISD did not create the integrated European regulatory space that had been its official goal.

As European financial markets evolved over the 1990s, the mood among both private and public actors began to shift in favour of further integration. Firms strengthened their representation in Brussels while voices for further action grew louder. The impending introduction of the single European currency and the growth of capital markets in continental Europe appeared to signal that the time had come to complete financial market integration.

By the beginning of the new millennium, a new picture had emerged. Market regulation had been harmonized and the policy-making process had become supranational—meaning that new supranational bodies had assumed central roles in policy-making, even if member states still retained an important role. Already in 1998 the European Council had asked the Commission to compile a report on ‘the way forward’ in financial market integration. The Financial Services Action Plan (FSAP) was the result, tabled by the Commission in May 1999 and endorsed by the European Council a month later. It listed 43 measures in order to complete EU financial market integration until 2005, including ‘upgrading of the ISD’ (European Commission 1999: 23).

Over the following years this ‘upgrading’ evolved into the most substantial overhaul of EU financial market regulation ever. The directive that came to replace the ISD was so different in scope and content that the earlier working title of ISD II was abandoned. It was rechristened the Markets in Financial Instruments Directive (MiFID) and adopted in 2004.

² Council Directive (EEC) 93/22 on investment services in the securities field [1993] OJ L141/27. Here art. 11(1) and 11(2).

MiFID negotiations were no less thorny than those for the ISD. Yet they produced a very different regime. The MiFID contains detailed rules on most aspects of capital markets and has effectively harmonized regulation. The liberty of national authorities to impose local rules on foreign operators as they see fit has disappeared; with the MiFID, a single passport in securities markets becomes a real possibility. For all practical purposes, EU securities markets are now governed by a single, EU-level rule set.

The *process* of rule-making has also been Europeanized. While the EU lacks a single financial regulator, the Stockholm European Council in 2001 agreed to implement a new decision-making procedure known as the ‘Lamfalussy process’ combining ‘comitology’ procedures with institutionalized consultation of an expert committee: the Council and the European Parliament agree on ‘framework legislation’ whereas decisions on the ‘technical details’—the so-called implementing measures—are left to the European Commission, scrutinized by a ‘comitology committee’ staffed by member state representatives and an advisory committee of national experts. These roles are fulfilled by the European Securities Committee (ESC) and Committee of European Securities Regulators (CESR, created for this purpose), respectively. The Lamfalussy process grants the Commission and CESR extensive powers.³ Even though CESR consists of representatives of national regulatory agencies, its technocratic, problem-solving outlook lets it operate as a rather coherent, supranational body. From being the integration-laggard, securities markets have become the front-runner among financial sectors.

CESR has since been recognized as one of the central bodies in EU capital market policy. It has two core tasks: once framework legislation has been decided in the co-decision procedure, CESR is charged with drafting implementing measures—the detailed legislation. The Commission turns the drafts into official policy proposals and, after scrutiny by the ESC, adopts them. CESR’s advice to the Commission is public, and as CESR is the recognized centre of

³ Both verbally and in writing, the Committee of European Securities Regulators is known as ‘CESR’ (pronounced like the Roman emperor Caesar), without an article.

expertise within the EU, the Commission is under pressure to justify departures from CESR's suggestions.

Once the details are agreed, national regulators, who are CESR's members, coordinate the transposition of EU measures into national law to prevent conflicting national versions of the same EU rule. Because implementation is a national affair, other EU bodies such as the Commission and the EP have no power in this area. By having agreed to the coordination of national rule implementation through CESR, national governments are committed to keep the governance process on a European level to the very end. Although national authorities continue to play a role, both through the Council and through CESR itself, they have largely Europeanized the rule-making process for securities markets. Whence this change of heart in less than a decade?

Limits of the existing literature

This case sits at the interstices of two debates: why do EU member states sometimes delegate policy-making to the supranational level? And why do governments open up financial markets and harmonize domestic rules with other countries? Scholars of European integration and financial market governance have addressed these two questions respectively. While their answers provide helpful starting points for investigation, they leave central questions unanswered.

European integration

Theorists of regional integration have sought to understand why and under which conditions political authority is relocated to higher levels of political aggregation—why, in other words, governments choose to 'pool' their sovereignty (Keohane and Hoffman 1991) and potentially delegate authority to supranational bodies, creating multi-level governance structures in the process (see Rosamond 2000, Hooghe and Marks 2001, Wiener and Diez 2004). In the EU context, the debate has traditionally been stereotyped as a clash between neofunctionalism (Haas 1958, Lindberg 1963, Schmitter 1970) and (liberal) intergovernmentalism (Hoffmann 1966,

Moravcsik 1993, 1998). In fact, while proponents of both have been at pains to highlight their differences, the differences are of emphasis. In the words of a prominent proponent of neofunctionalism, Philippe Schmitter,

[i]f Moravcsik were to concede that the calculation of member-state strategies was affected not only by 'domestic interests', but also (and even increasingly) by transnational firms, associations, and movements working through domestic channels, then, his approach would be virtually indistinguishable from neofunctionalism [...]. (Schmitter 2004: 72, endnote 2)

Neofunctionalism and liberal intergovernmentalism agree that actors build supranational institutions because of their expected effects (Schmitter 1970, Scharpf 2001). Nevertheless, two points have proven especially contentious: first, can integration theory say anything systematic about the conditions under which governments find integration desirable? And second, how does integration achieved thus far affect eventual future integration?

The most common answer to the first question—one that is shared with much regime theory (Krasner 1983, Hasenclever et al. 1997)—is that governments integrate policy-making when they face common problems that can be solved more efficiently or effectively through a bundling of forces (Scharpf 1997, 1999). But it remains unclear where and how problems are defined. Neofunctionalist approaches often suggest that nation states simply face them and have clear ideas about desirable solutions (Niemann 2006 is an exception). In many policy areas, however, both the nature of common 'problems' and desirable 'solutions' are far from obvious (Adler 1991, Hall 1993). Certainly in a complex field such as the governance of capital markets, government preferences are not simply given. Their origins have to be explained.

In addition, scholars who focus on the 'problem-solving capacity' of supranational governance seldom specify *whose* concerns are actually addressed through integration and why some issues come to the fore rather than others. Certainly in the economic sphere, different social groups are likely to have different, if not opposing, interests. Just how national governments aggregate domestic preferences remains vague. Scholars of regional integration

realize that the gains of easier cross-border trade and investment are not distributed evenly throughout society (Schmitter 1970, Stone Sweet and Sandholtz 1998, Mattli 1999). This is even more the case for explicitly critical approaches to European integration (e.g. van Apeldoorn 2002, Bieling 2003, Holman 2004) which argue that the uneven distribution of benefits is not only a side-effect of integration, but one of its driving forces. What unites both kinds of approaches is their tendency to equate effects with causes. They assume that beneficiaries have been instrumental in bringing about regional integration, without showing how or whether this is indeed the case. Knowing who has benefited from supranational capital market governance is insufficient without an argument explaining how these actors have tilted political arrangements in their favour.

The intellectual leap of faith from effects to causes is disconcerting because regional integration—certainly in an organization as complex as the European Union—is prone to producing unintended effects (Pierson 1996). Institutional outcomes do not necessarily reflect the interests of those actors who effected institutional change in the first place (Pierson 2000). This makes it impossible to read political input into supranational institutions and the core agents behind such input from the effects such institutions generate. It calls for an approach to studying supranational governance that traces the actual political process that brought integration about, thereby identifying its core actors and the specific contexts and compromises that shaped regulatory and institutional outcomes.

In light of these difficulties, some scholars have chosen to search for the rationale behind integration not among the macro-effects it produces but in its immediate benefits for those who ultimately decided on it: public officials. Marks et al. (1996) suggest two motivations for government officials to support multi-level governance and the supranationalization of political authority. First, politicians might want to reap the *political* benefits of more efficient policy provision. Second, they might shift decision-making to the European level because they ‘may prefer to avoid responsibility for certain policies’ or because they want ‘to insulate [decision-

making] from political pressures' (Marks et al. 1996: 349). The transfer of responsibility for monetary policy to the European Central Bank (ECB) is an example.

Applied to capital markets, both answers fail to satisfy. Financial market integration does not help to win elections. Nor is financial regulation so onerous for the electorate that political damage can be avoided by shifting decisions to the European level. Finally, even if governments desired to 'insulate' financial regulation from their own intervention, it is unclear why this would necessarily lead them to supranational integration. Many national regulators already enjoy a high degree of independence from government—just as the German central bank was already highly independent before the creation of the ECB.

The second contentious question—whether past integration might lead to more integration in the future—has typically been answered positively. A number of potential channels have been identified (recently Niemann 2006). Once created, supranational elites (the European Commission is the obvious example) generate their own 'supply' of solutions to problems faced by nation states, possibly exploiting common problems to strengthen the relevance of supranational institutions.

Past integration may also lead formerly domestic actors to develop transnational identities, potentially based on their material interests. Such actors may then push national governments to integrate further—business associations would be a case in point (Cowles 2001). As Feld wrote in the early 1970s,

[a]nother by-product [of previous integration] is the gradual emergence of an expanding, relatively young, Europe oriented business elite as the result of the subtle political socialization process operative in the coordinating mechanisms of collaborating entities. [...] [T]hey may be in time influential, through cross-communication with other elites, in soliciting support by the member governments for harmonization measures and for the community system in general. (Feld 1970: 237f)

Feld and his intellectual successors, however, did not sufficiently specify when such a business elite would push in this direction, and—even more importantly—why governments would heed its call.

In sum, theories of European integration have tended to underspecify either the motivation behind supranational governance or the actual process through which diffuse social preferences are translated into institutional change. At the same time, they have offered no general theory explaining when past integration generates further integration. These shortcomings are not necessarily material defects. But they call for empirical inquiry to trace the actual political process propelling integration forward, instead of relying on stylized depictions of the role of governments in politics. In addition, they encourage the exploration of other sources of theoretical guidance to fully understand integration dynamics.

Financial liberalization and integration

Actors with a stake in *substantive* rules (financial market regulation) can be expected to take an active interest in *procedural* rules (policy-making institutions) as the latter preconfigure the former (Milner and Keohane 1996: 4). The logic of this argument can also be applied to multi-level governance so that one should expect a relationship between the supranationalization of rule making procedures and the policy of financial market opening.

Such market opening has not been exclusive to the European Union. As Pauly already found in the late 1980s,

[i]f relevant [financial market] policies are grouped and compared along a theoretical spectrum ranging from closure and discrimination to openness and nondiscrimination, by the 1980s most states of the OECD moved decisively in the latter direction. (Pauly 1988: 5)

The trend has since continued (J. Williamson and Mahar 1998) and scholars of financial liberalization have sought to explain it (e.g. Quinn and Inlcan 1997, Simmons 2001, Simmons and Elkins 2004, Singer 2004). The Europeanization of capital market governance, however, is not

easily squared with the approach common in such scholarship. Almost all studies on financial liberalization—including those dealing with European cases—conceive of market liberalization as a unilateral national-level affair. The country-level focus of many studies narrows the range of eligible explanations to an interaction between domestic and ‘systemic’ factors such as technological change or capital mobility. Few studies seriously consider plurilateral or multilateral negotiation as sources of liberalization and thus ignore a central channel through which governments ‘make markets’.

Yet financial market opening is often conditional upon the actions of other governments, as shown by examples from the Pacific region and the WTO (Pauly 1988, Underhill 1993, Sauvé and Gillespie 2000). This is even more the case in the EU: almost all market opening is negotiated and reciprocal. Much extant scholarship thus has a double limitation: it ignores international negotiations and bargaining as a source of market opening. And it ignores the possibility that governments may build political institutions beyond the nation state to address policy concerns, using them as an alternative to unilateral policy change.

With these caveats in mind, what are the driving forces behind financial liberalization that scholars have identified and that might help explain the supranationalization of EU capital market governance? Roughly, the answers can be put into two categories: financial globalisation and domestic politics.

The two most prominent arguments about financial globalisation focus on capital mobility and technological progress. Laurence (2001) for example argues that capital mobility has shifted power away from banks and towards investors. Previously, banks used their weight in domestic policy-making for the purposes of rent-seeking and closing off domestic markets. But since the advent of capital mobility, this has been trumped by the exit option of investors. Hence policy is reformed to reflect investors’ preferences—for example more openness and transparency, lower prices, the abolition of cartels and increased competition. In this perspective, banks are the losers of market opening. International openness and regulatory competition (Esty

and Geradin 2001) lets national policies converge around the imperatives of what Cerny (1990) has called the ‘competition state’.

Technology as a driving force receives most attention in the economics and business literature (e.g. Holland et al. 1998, Smith and Walter 2003). Technology has removed obstacles to integration stemming from the geographic dispersion of financial activity or discontinuities between currency areas. The former can easily be bridged with modern information and communication technology. The latter can be neutralized with hedging techniques that advanced financial engineering makes possible. With both barriers removed, goes the argument, the opportunity costs of countries watching global financial developments from the sidelines increase. Hence governments open up their markets.

Both of these arguments are attractive. But they also have weaknesses. Arguments about capital mobility as a driving force have two flaws. First, capital mobility itself is never properly accounted for. Rather than being a ‘thing’ in itself, it is the result of various policy measures that facilitate the movement of capital across borders. In effect, such arguments explain public policy outcomes (the opening of financial markets) with earlier public policy outcomes (introducing capital mobility) without ever going into detail about the underlying political processes and compromises. These approaches remain insensitive to the structuration of the political economy: market structures may influence government policy, but government policy also clearly affects market structures. It is far from obvious that one is ontologically prior to the other.

Equally important, the facts of financial market development do not easily fit the capital mobility hypothesis. Rather than being losers of liberalization, big (investment) banks continued to earn record profits until the financial market upheaval that began in the summer of 2007 (Augar 2005). These profits are due to the fact that, in contrast to the model, large banks are highly mobile. Their presence is global and their global market share continues to increase (Group of Ten 2001). In addition, there is little empirical support for regulatory competition in financial services at either the European or the international level (Hertig 2001, Trachtman 2001).

Finally, investors are not known for their political connections or their involvement in public policy. Regardless of abstract ‘bargaining power’, it is unclear how their preferences are translated into public policy. Approaches stressing capital mobility fail to account for the ‘agency’ through which policy changes are actually brought about.

The technology argument has similar flaws. Undoubtedly, technology matters greatly to financial markets as we know them today (Lee 1998). It is far from obvious, however, that technology simply pushes market developments in one direction or another. Why is the efficiency-enhancing potential of technology exploited in some instances but not in others? Why, to take one example, do investors in some jurisdictions still have to use (and pay) brokers for the execution of stock market trades, even though it has long been technologically feasible to connect them to the market directly (Mahoney 2002)? Technology makes market restructuring *possible* but it does not in itself explain why it happens in some cases and not in others.

In addition, most information technology in financial markets is proprietary. Technology does not simply appear out of nowhere; it is used strategically by firms that invest immense sums in it. Technology is not exogenous to the dynamics among market participants, but rather a ‘box of tools’ the latter use to attain their goals. That makes it a weak explanation for market changes that public policy might ‘adapt’ to. Indeed, governments themselves can use regulation to limit the application of technology. For example, European stock exchanges have traditionally not been allowed to place trading screens in other countries even though this had long been possible. In summary, arguments about system-level properties such as capital mobility or technological progress as a source of policy change ring hollow without analysis of why actors introduce or obstruct either. They are also not very helpful for explaining why governments might favour supranationalization and cross-border integration over national governance and control.

From a normative perspective, regulation of domestic financial markets provides public goods (see e.g. Vittas 1992, Herring and Litan 1995, Goodhart et al. 1998). Politicians and bureaucrats themselves justify regulation and its reform this way. Indeed, addressing market

failures *is* an important function of market regulation. Even if the danger of financial crises—the most immediate reason for market correction—has long been considered relatively low in the Northern hemisphere, other public functions remain important: the cheap provision of quality financial services and the prevention of fraud that can thrive on ubiquitous information asymmetries.

Even a cursory reading of the evidence, however, suggests that regulatory politics involves more than debate over the optimal production of public goods. Empirically, regulation is rarely a question of the state reigning in market excess. Rather, regulation is jointly produced by public and private actors while regulatory policy reflects diverse societal interests (Braithwaite and Drahos 2000, Clarke 2000). Sceptics argue that this makes ‘regulatory capture’ possible. Building on Stigler’s (1971) classic account, regulation in this perspective is contested primarily between producers and consumers. The latter systematically lose out to the former, he argues: producers have a high stake in regulation and make more determined efforts to influence policy. And because of their smaller numbers, producers can organize more easily. Both reasons together tilt regulation in their favour.

Such an argument, however, does little to explain the *variation* in institutional change over time and across jurisdictions. It assumes that the central division of interests in regulation runs between consumers and producers. In the realm of securities markets, this is far from clear. Many large financial conglomerates fulfil a range of functions: they act as investment vehicles, analysts, have stakes in clearing houses and securities exchanges, arrange initial public offerings, etc. They are simultaneously consumer and producer, often in overlapping products. The only consumers that truly deserve the label are retail customers. Stigler’s theory predicts, probably correctly, that they regularly lose out in market regulation. But this says little about the rest of regulatory politics. Furthermore, his original idea is not easily reconciled with the trend towards market opening. If producers were still in charge, why would they want to invite foreign competition? Their regulatory preferences and how they would change remain undertheorized in Stigler’s

approach.

Vogel's insight (1996) that 'freer markets' tend to need 'more rules' has compounded the problem. Effective market liberalization takes more than just deregulation. From liberalization's emphasis on *enforcing* competition in domestic markets, Vogel concludes that governments must have had more room for manoeuvre than theorists of regulatory capture grant them. In his view, governments have updated regulatory systems to keep up with a changing environment. Still, the question remains why governments—allegedly in charge—would choose to harmonise rules and surrender national autonomy in financial market policy-making.

The final angle on regulatory reform in financial markets has been developed by Andrew Sobel (1994), who argues that struggles over regulatory reform are fought neither between producers and consumers of financial services (Stigler et al.), banks and international investors (Laurence), governments and national financial industries (Vogel) or states and imperfect markets (normative approaches). Instead, different groups of domestic producers of financial services struggle over regulation to either protect their own turf (in the case of market incumbents) or invade that of others (market challengers). He points to financial reforms in Japan, the United Kingdom and the United States as examples; in all three countries the division between securities markets and credit markets has been diluted due to conflict between incumbents and challengers. Sobel's approach is convincing for the cases he analyses. But as presented, its applicability is limited. It does not easily lend itself to countries that traditionally have no division between banking and capital markets, for example Germany, or to a lesser degree, France.

More importantly, Sobel's approach, like the others, does not easily accommodate the supranationalization of policy-making and the emergence of multi-level forms of governance. Depending on the dynamic hypothesized to lie behind liberalization, such supranationalization could play very different roles: is it a bulwark against the corrosive effects of global economic pressures, for example regulatory competition? Is it a vehicle for governments seeking to update their regulatory systems optimally? If so, why would they harmonise policy and surrender

autonomy? As pointed out, EU member states in the early 1990s were loath to do either; in many policy fields, this remains the case. Why, then, the shift in capital market governance? The following section outlines how this thesis responds to this question.

Conceptualizing the political economy of competition politics

The dynamic at the heart of the supranationalization of EU capital market governance—firms using their political power to manage competition through regulation—can be labelled ‘competition politics’. Competition politics are an instance of social structuration (Giddens 1984) where actors collectively and interactively shape the environment (the ‘structure’) that they confront. This process extends to the political institutions where regulation is made: agents try to influence the institutions, anticipating their effects on rule-making.

Market structures, regulation and political institutions are thus interdependent, a view most political economists would readily accept and one which has been discussed at length within institutional economics (O. Williamson 1987, North 1990), economic sociology (Fligstein 2001, Swedberg 2003) and comparative political economy (Hollingsworth and Boyer 1997, Hall and Soskice 2001). In contrast, what ties the three together—the political agents who struggle over the form which markets will take, the rules that govern them, and the political institutions that give access to some actors but not to others (see Underhill 2006)—have received little systematic attention.

It matters *who* the influential agents are. Markets, their regulation and the political institutions governing them would look rather different depending on who is best able to shape outcomes—investors, retail consumers or regulators. To understand why contemporary EU capital market governance looks the way it does, it is not enough to state that markets, regulation and political institutions are interdependent. The crucial question is *how* they are interdependent.

The conceptual answer to this question, detailed in chapter 2, can be broken down into five sub-questions. First, what explains firm preferences for regulation and a particular shape of the market landscape? Second, what explains the pre-eminence of their preferences relative to

other stakeholders? Third, under what conditions do coalitions for market change emerge?

Fourth, how are agent preferences linked to institutional change, in particular supranational governance? And fifth, how do the outcomes of this process—market integration and institutional change—feed back into firm preferences?

Regulation, political institutions and firm preferences

Firms care about regulation because it structures the competitive environment, meaning it sets the terms of competition among them. Regulation shapes markets, and economic agents have diverse preferences in this regard. Three dimensions are particularly relevant here: first, regulation determines the products available on a given market, and their potential substitutes. Second, regulation determines which kind of firm can offer which kind of (financial) service. Third, regulation determines how foreign firms are treated relative to domestic ones. For example, can foreign firms simply sell their products to domestic clients? Do they have to follow domestic rules? Do they need a local presence or a separately funded subsidiary? Are there special rules that apply only to foreign firms?

Taken together, these three dimensions of regulation delimit the competitive environment in which firms interact. When regulation is fixed, firms will adapt to the environment, using their resources to take maximum advantage of their regulatory environment. Firms that fail to benefit from restrictions on competition may perish. Successful ones—the ones that eventually dominate the market segment and become the ‘market incumbents’ (Fligstein 2001)—are likely to support the way regulation structures competition. Regulation provides security by preventing ruinous competition. This means that *regardless of the original intention behind market rules*, a political constituency will develop that will be against rule change because it profits from current arrangements. This does not make it impossible to change the competitive environment, but the political power of market incumbents makes it difficult.

The institutional power of financial firms

Banks' regulatory preferences only matter to the degree that banks are successful in translating them into public policy. The institutional power (Barnett and Duvall 2005) that enables them to do so derives from their central position in national economies. Complex financial systems enable large-scale division of labour and generate credit, which are crucial ingredients for economic development (Germain 1997). They also allow the state to collect taxes efficiently (Ingham 2004). The state and society at large therefore have an interest in well-functioning and stable financial systems—and this includes thriving banks, which constitute the core of financial systems. States are much more likely to listen to the business concerns of banks than to those of firms in other sectors.

The attention that states bestow on their national financial industries translates into preferential access to public policy. States often closely monitor developments in financial markets and the financial industry. They hold regular consultations with banks and other financial firms to discuss policy. This access to policymaking is a generalizable power resource that banks can use for a wide range of purposes.

In addition to these general sources of political power, banks have specific power resources that depend on the model of capitalism in which they operate. In coordinated market economies (Hall and Soskice 2001), financial markets—and the firms operating within them—often have special economic functions. For example, banks are used as channels for central banks' monetary policy. States often target credit at specific social or economic sectors to stimulate development or investment. Banks have also played an important role in industrial policy: in Japan and Germany, two prominent examples of coordinated market economies, banks were given central positions in a web of corporate cross-shareholdings (Yamamura and Streeck 2003). The pre-eminent role of banks in national economies entailed close connections with the state and preferential access to policy-making in addition to an enormous direct influence on economic outcomes through their business activities.

Finally, firms in financial services, as in other industries, can receive special political consideration due to their economic relevance—for corporate taxes or employment. In the UK, the share of financial services in total GDP is over 10 per cent; directly and indirectly, financial services generate a lot of employment. As is the case with cars in Germany and agriculture in France, the state will heed the business interests of prominent sectors. Where regulation limits the domestic access of foreign firms, international regulatory politics resembles trade politics. Just as governments defend the interests of their national champions in trade negotiations, they take heed of financial firms' preferences when financial market rules are negotiated with other countries.

In a number of ways, then, the interests of financial market incumbents have been built into state preferences. Regulatory policy is not a domain in which regulators and regulated stand opposed. Rather, the state and market incumbents jointly develop the rules that govern markets, temper competition and thereby generate the stability that both cherish (Clarke 2000).

Integrating markets

The view presented thus far is more static than what prevails in reality. At the heart of this thesis is not stability, but change—in regulation, political institutions and market structures. How do transnational rule harmonisation and supranational governance fit into the perspective developed thus far?

Change in competition-relevant rules depends on change in market incumbents' preferences. Put simply, incumbents are likely to support changing rules if they see greater chances for economic success in the new economic landscape. In Sobel's (1994) account, commercial banks in the US, the UK and Japan were performing poorly. Firms active in capital markets, in contrast, were earning record profits. With little to lose and much to gain, commercial banks in all three countries pried open capital markets to gain a share of that business. Kroszner and Strahan (1999) tell a similar story for inter-state branching in the US: banks had reached their limits of growth within state borders and began lobbying for easier access in other states and

other sectors. In the end they were successful. Market liberalization becomes a function of market incumbents reaching limits of growth and seeking opportunities elsewhere.

Transnational market integration affects existing firms and the political basis of support for stability or further change. Smaller and mid-sized firms competing with large ones are likely to lose out in market integration, and either vanish or find a niche. Either way, their political influence will likely wane. The political support for a protectionist regulatory regime fades as supporters of integration come to seek cross-border markets and are able to assert their preferences (cf. Milner 1988).

This logic applies to EU market integration as well. On the one hand, relatively weak regulatory barriers—like the need to comply with local rules—can be sufficient to make market entry unattractive to outsiders. Even in the single market, governments can use market directives to keep competition at bay. On the other hand, the single market can provide growth opportunities firms do not enjoy domestically. Examples include telecoms, utilities and airlines. Particularly for economies of scale, interest in integration will be strong.

Supranational governance

In the context of the European Union, preferences for supranational governance relate to those on market integration. As understood here, supranational governance means even detailed rules for a particular political domain are decided collectively at the EU level, with supranational actors having considerable influence over them. In a multi-level governance setting, governance will rarely lie completely at the national or supranational levels. A body such as CESR combines supranational and international elements; in its daily operations, it functions as an organization whose primary allegiance is to EU capital markets as a whole. Supranational governance can thus also be thought of negatively as the absence of national or international governance.

Firms that favour market integration will likely prefer supranational governance for a number of reasons: transnationally harmonized rules facilitate cross-border market access while

nationally idiosyncratic rules obstruct it. As Scharpf (1997) has pointed out, supranational governance can increase the ‘problem-solving’ capacity of organisations such as the EU by reducing collective action problems. Agreement on collective rules, and thus transnational regulatory harmonization, is facilitated by supranational governance. Needless to say, such harmonization requires consensus among powerful actors on the ‘problems’ and their ‘solutions’.

Over time supranational governance also tends to decrease the political power of those actors who oppose market integration. Pro-integration firms share a political agenda with—and are the natural constituency of—supranational actors such as the Commission. The Commission in turn looks for allies to support its cause vis-à-vis other EU bodies, for example the European Council and the EP. Smaller firms with protectionist inclinations have difficulty legitimizing their position in supranational forums and have to rely on national governments to represent their interests. As Stone Sweet and Sandholtz (1998) have pointed out, all this makes economic beneficiaries of integration likely supporters of supranational governance.

The technocratic bias of EU governance, with its preference for open markets, increases this tendency. The same is true for expertise. Supranational bodies, and to a lesser degree national ones, depend on banks for market expertise. The effectiveness of regulation depends on the behaviour it triggers among market participants. Rather than proceeding via trial and error, regulators discuss policy design with banks in advance, often through regular consultations. Banks of course have their own self-interested perspectives on issues, and it is therefore not always easy to tell the difference between them and disinterested technical advice. The staffing limits of supranational bodies make them vulnerable to subtle manipulation.

Large firms have further advantages in Brussels. Collective action problems have long made it difficult for large groups—for example consumers—to have their interests represented in domestic political systems (cf. Olson 1965). It is even more difficult at the EU level, where the number of relevant political actors has multiplied. In addition to the EP, the Commission and

CESR, the support of numerous governments is needed to get policy agreed. Navigating the institutional jungle requires expertise and resources, both of which large firms have.

This does not mean that the Commission—the principal supranational body of the European Union—has no independent room for manoeuvre with respect to the integration process. It can influence the public agenda, control the flow of information and, if matters hang in balance, play actors off against each other (Pierson 1996, Pollack 1998). The Commission can catalyse integration, and in our case, has used its powers accordingly (cf. Gottwald 2005). The agency of the Commission, however, is limited. It could not have moved integration forward if the financial industry—and thus member states—had opposed it.

Structuration dynamics

The perspective advanced here emphasizes the agency and preferences of actors with privileged access to the state and policy-making. Agency and preferences are tied to developments in actors' political, institutional and economic environments. It matters how potential allies and opponents are situated in the field. In addition, the influence of particular actors depends on their position in political institutions and the make-up of states (Krasner 1984, Ikenberry 1988). Actors also find that their economic environment constrains their options. Shifts in political, institutional or economic structures can change policy preferences and thus trigger agency.

Giddens (1984) coined the concept 'structuration' for this feedback loop between structure and agency. The dynamic at the heart of this thesis is one of market structuration: actors—both public and private—aim to change market structures in light of their preferences; these preferences in turn bear the strong imprint of past changes in market rules, political institutions and actors' economic environment. Both regulation and policy-making institutions can be understood as tools in the market-structuring project that public and private actors pursue. Because actors can use political power to advance their economic interests, and their economic power to advance their political interests, an equilibrium can emerge in which a 'fit'

develops between market structures, market rules and political institutions. The resulting ensemble is what Underhill (2001, see also Underhill and Zhang 2005) has called a state-market condominium. Indeed, the stability of this ensemble is often seen as the norm, or point of departure, for analysis in comparative political economy (Hall and Soskice 2001), studies of the state (Krasner 1984, Cerny 1990), economic sociology (Fligstein 2001) and critical approaches to political economy focusing on hegemony (Cox 1996).

For the supranationalization of governance and transnational market integration, two ideal-typical ‘constellations’ of rules, market structures, political institutions and actors can be discerned: an ‘international constellation’ and a ‘supranational constellation’. In the international constellation, tightly knit national policy communities, markets fragmented along national lines and nationally idiosyncratic regulation complement each other. The opposite is the case for the supranational constellation: rules are harmonized, markets integrated, and policy communities open and internationalized.

The shift from one constellation to the other—realized by agents who are aware of the complementarities and who ‘translate’ shifting market structures or new regulatory preferences into institutional change—is far from smooth. With agency as the crucial link in the structuration chain, theoretical complementarities do not lead to neat structural adaptation. Both the market structures and the political environments actors face are too complex for them to always devise straightforward strategies. Actors make mistakes. Firms may miscalculate their chances of success in foreign markets. The complexity of EU institutions makes it difficult to predict political outcomes even in light of known political inputs. In addition, political institutions and market structures can be influenced by factors that lie outside the structuration dynamic in question. Potential ruptures in the feedback loop make the study of empirical detail as crucial as the study of encompassing political economy dynamics.

The argument: competition politics in EU capital markets

As an application of this competition politics framework, the core argument of this thesis can be summarized as follows: the supranationalization of EU capital market governance can best be explained by the shifting preferences of and alliances between a small group of private actors—banks and investment banks active in capital markets—and their public sector interlocutors. The political preferences of these private actors have been formed in response to the expected impact of regulatory and institutional change on their competitive position, rather than just profits per se. These preferences shifted in favour of integration as firms' market environment changed; many of them began to perceive a competitive advantage in transnational market integration whereas they had previously preferred regulatory protectionism. True to the structuration perspective at the heart of this thesis, market transformation was itself the result of regulatory changes which private-public coalitions had pushed through since the mid-1980s.

The overall result of this mutual constitution of market structures and patterns of governance—mediated by a small group of self-interested actors—has been a state-market constellation where the 'scope' of markets once more matches that of political institutions. Also informally, large financial firms cultivated their ties with supranational bodies such as the European Commission at the expense of traditional connections with national governments, even if banks' domestic influence continued to loom large. This does not mean that integration was a smooth process: the importance of agency in effecting change has meant that both the process of change as well as the end-result—the regime that governs EU capital markets at the time of writing—are riddled with inner contradictions, inconsistencies and unintended consequences.

How does a competition politics approach account for the supranationalization of capital market governance in the EU? The remainder of this section spells out this thesis' answer to that question. Around 1990 continental European banks were focused largely on their domestic markets. Only the American investment banks conducting their business out of London had

significant European operations and clear ambitions to expand them. Weighing the benefits of effective cross-border integration (market access abroad) against its costs (heightened competition in home markets), most continental firms strongly preferred a protectionist regime over true market opening. Nationally idiosyncratic rules and national discretion were thus left intact.

Deteriorating profit margins in the credit business, a global stock market boom and growing, if limited, international market openness triggered a strategic re-orientation among many large banks in Europe throughout the 1990s. Many developed European—if not global—ambitions, while the capital market business was discovered as a source of profits in its own right. Their preferences shifted in favour of EU market integration and reduced transaction costs for cross-border operations and hence in favour of rule harmonization and more supranational governance.

How could such a small group of firms command such influence over capital market governance? This thesis does not argue that governments—or the European Commission, for that matter—were puppets of the financial industry. It does argue, however, that as one among many stakeholders in capital market policy, banks have had power resources at their disposal that have given their interests disproportionate weight in policy-making (Lindblom 1977). They have been the central private actors in public-private alliances which first obstructed and later pushed for market integration by political means.

Domestically, firms in the financial sector have long enjoyed privileged access to policy-making. In Germany and France, the central role of banks in the management of national economies turned them into insiders in economic policy. Large German banks assisted the Bundesbank in monetary policy. They provided long-term financing to domestic industry and were at the heart of the net of cross-shareholdings known as Deutschland AG. French banks were important channels for government distribution of credit throughout the economy, even after many were privatized in the late 1980s. The history of state intervention and public

ownership in French finance had also generated close personal ties between the state and its banks. In the UK, the financial sector's influence over government policy stemmed mainly from the government's interest in a thriving City: financial services account for more than 10 per cent of UK GDP, much of it concentrated in London. In all three countries, the interests of national financial industries were built into government policy. Agreement in the European Union largely depended on the homogeneity of views within the industry itself.

This is not to suggest that banks of various national origins active in EU capital markets have always held similar preferences. Indeed, the conflicting interests of banks largely explains the restrictive regime that emerged in the early 1990s. And later, while conflicts remained, fault lines no longer ran along national borders. Instead, large banks from across Europe were jointly pitted against smaller firms and increasingly against national stock exchanges too. Among the top banks—as well as large bourses—a consensus emerged in favour of cross-border market access. As chapter 5 details, with more than 90 per cent of the EU capital market business concentrated in the hands of less than two dozen firms, agreement among them constituted a *de facto* industry consensus. Through their privileged access to government policy, this consensus informed government opinion to a degree that would have been unthinkable in most other sectors.

Financial firms trumped other stakeholders in Brussels as well. As they successively developed pro-integration preferences, they discovered the European Commission and later the European Parliament (EP) to be natural allies. Neither needed to be convinced of the desirability of further integration. Firms nevertheless lobbied heavily, both individually and through organizations such as the European Banking Federation (EBF) and the London Investment Banking Association (LIBA). The Commission created consultation committees with industry leaders to find out where, in their view, the single market 'worked' and where it did not.

Equally important, banks' political weight in domestic politics made them sought-after political allies for the Commission; against their resistance, progress in capital market integration was all but impossible. The industry voiced its support both for the abolition of cross-border

barriers and for more technocratic, supranational governance—in national capitals as well.

The under-representation of other societal stakeholders was the flip-side of this intensive industry input. Most obviously, smaller banks from around the EU have had little voice in negotiations, both individually and through business associations. As the European industry consolidated on the back of regulatory market integration and a new European ‘Champions League’ of investment banks emerged, small banks have been the most visible losers of this process. But other financial market stakeholders have also been (surprisingly) absent: non-financial corporations that issue securities, institutional investors such as pension funds, and of course retail consumers. Most importantly, the central role of policy community insiders squeezed out the interests of a broader public—a point driven home by the consequences which the credit crises erupting in the summer of 2007 have already had for economic growth and employment in Europe.

The European Commission’s role has thus been one of a catalyst. It has been a focal point for supporters of capital market integration and its policy initiatives have provided political space for integration to go forward. Skilful manoeuvring has also allowed the Commission to inject its own priorities into policy. However, without the support of the European financial industry, the Commission’s efforts would have led nowhere. They would have been stymied, just as they had been in capital market negotiations around 1990 and in many other policy fields since. The visibility of the Commission’s role in capital market policy has belied its political dependence on the most powerful constituency in capital markets: the banks.

Taken together, this means that competition among firms *within* European capital markets has been key to the way the governance *of* these markets has developed. As the business outlook and activities of European firms became more international, market governance was supranationalized. Market transnationalization and supranational governance moved in sync; market participants were the link between the two. Two caveats apply, however: this link is not unidirectional, and it is not deterministic.

Banks' preferences and attempts to influence market rules depended on the threats and opportunities they perceived. For example, the stock market boom in the second half of the 1990s fed EU-wide capital market enthusiasm and optimism among banks and governments. It inspired banks to further push integration and helped sway governments in favour of market opening. In this way, market developments themselves fed into governance change, *mediated by the interests, perceptions and political power of firms*. At the same time, in the decade preceding the stock market boom, banks in Continental Europe had lobbied heavily for the rule changes that had made it possible for stock markets to become so prominent in the first place. The process is thus one of structuration: market developments, political agency and institutional change influence each other over time. Market transnationalization has encouraged supranational governance, and supranational governance has been used to further boost market integration.

Because the link between market transnationalization and supranational governance involves political struggle and agency, the relationship between the two was not always straightforward. With hindsight, actors have made strategic mistakes and miscalculations. For example, many mid-sized banks supported capital market integration, believing they could profit from it. In the end, the majority of them—for example Dresdner Bank, Commerzbank and Crédit Lyonnais—abandoned their European (let alone global) ambitions. But market integration had in the meantime become a fact. Public actors also miscalculated: in the late 1990s the German and French governments saw Frankfurt and Paris as serious competitors to London, something that helps explain their support for integration at the time. It turned out to be wholly unrealistic but market integration had been signed up to.

The most prominent example, however, has been the demutualization of European bourses. As both members and owners of stock exchanges, banks turned them into independent, for-profit firms during the 1990s. In doing so, they unwittingly created what a decade later were to become their fiercest competitors for share trading. When the ISD was renegotiated in the early 2000s, stock exchanges formed the most vocal and effective opposition to banks' wishes for

a liberal trading regime. The eventual outcome of those negotiations, the Markets in Financial Instruments Directive, bore the clear imprint of the competitive preferences of bourses—a group of actors that had not even existed as independent firms a decade earlier. Unintended consequences and the unpredictability of market evolution and political processes have thus played their part in creating current arrangements. And they underline the importance of agency relative to mechanisms operating at the macro-level.

Scholarly and societal relevance

The central contribution of this thesis lies in its conception of competition politics—a process of market structuration through which a small group of public and private actors translate their political preferences into market change. By showing how market structuration and regulation form an integrated process, and can only be fully understood as such, it goes beyond the insights of the various theoretical approaches on which it draws.

The competition politics perspective advanced here challenges core tenets of common views on European integration and financial market liberalization. With respect to the former, this thesis shows that integration has been driven and shaped by the material interests of a small group of identifiable actors—not by free-floating identities, supranational loyalties or the hope to optimize the provision of public policy which neofunctionalist approaches routinely highlight. By redefining the place of national governments in economic governance it defies the neoliberal intergovernmentalist idea that these governments, or their purely domestic constituencies, were still in charge. Both the competitive dynamics as well as the patterns of political association and exercise of power in this case have clear transnational and supranational dimensions. And by showing the relevance of political agency (and its unintended consequences) for integration, it contradicts more structuralist versions of historical materialism and deterministic views of political economic change.

This last point is also the main contribution to our understanding of financial market change, and liberalization in particular. This thesis does not deny that market structures and

factors such as technology have an impact on changing rules and governance patterns. But it shows how these factors matter *by way of agents* who use regulatory and institutional changes as means to attain their commercial and political ends. Without an understanding of these ends and the resources actors command to implement them, any picture of financial liberalization will remain incomplete.

The importance of political agency—and thus political choice—for changes in both governance patterns and ultimately market structures as well immediately raises normative questions: is the influence of banks over capital market governance a reason for concern? What does the argument imply about the legitimacy of how capital markets are governed in the EU? The answer to this last question can be split into two parts: output-oriented legitimacy—the degree to which ‘the common welfare’ of the broader public is promoted—and input legitimacy—the degree to which current arrangements reflect the ‘authentic preferences of the members of a community’ (Scharpf 1999: 6).

From the perspective of output-oriented legitimacy, smoothly functioning capital markets are preferable to those that are crisis-prone. Market complexity means that expertise is indispensable for effective policy. Involving financial firms—where expertise is most concentrated—can therefore help to improve policy. Beyond this, the effect of private influence over public policy is ambiguous. It is not obvious which kind of policy promotes the ‘common welfare’ or, indeed, just what that common welfare is. After all, financial regulation has quite disparate effects: it may increase or decrease the chance of financial crises. But it also influences the distribution of credit in society. Through promoting stock market listings, regulation may push firms to concentrate on short-term profits and lay off employees. It may create new investment opportunities for individuals but also promote financial products whose risks they do not understand. The interests of debtors and creditors, investors, managers, workers and banks themselves are at odds on these questions, and ‘the common welfare of the constituency in question’ is elusive. In other words, the pre-eminence of private actors in capital market

governance cannot simply be justified by reference to ‘better’ policy. For whom is it ‘better’? Financial innovation can clearly generate public benefits. Money and credit have certainly multiplied societies’ potential for welfare. At the same time, financial innovation as a means for banks to generate profits also often stands at the heart of periodic crises (Galbraith 1975; Partnoy 2002); the subprime mortgage meltdown is only the most recent example. Even though the full effects of supranational capital market governance in Europe have yet to emerge, such examples instil caution about policy communities in which a small group of inside firms wields such power. The question thus arises how well the interests of different social groups are represented in policy-making or, to put it simply, how democratic current arrangements are.

The centrality of private interests in public policy is not easily squared with democratic expectations. The argument here is not that banks and public actors have conspired against the general public, but that the political process is systematically tilted in favour of banks, regardless of the awareness and intentions of public actors. Pluralist notions of supranational ‘governance *with the people*’ (Schmidt 2004)—meaning governance with social interest groups rather than direct democracy or parliamentary representation—raise questions. In spite of (largely futile) efforts by the Commission to involve ‘the man on the street’ in the policy process, the interests of social constituencies outside the financial industry are underrepresented in capital market governance.

Private involvement in public policy-making would be less problematic if it was subordinated to rigorous democratic control that ensures policy would eventually promote the ‘authentic preferences’ of EU citizens. However, parliamentary representation—national or European—provides little assurance. National parliaments are only marginally involved in EU capital market policy. The domain is shared by finance ministries, regulatory agencies and central banks—the actors involved in the negotiation of EU rules. National parliaments normally have to ratify the laws implementing the results of these negotiations. Even if national parliaments could

exercise more oversight in theory, the complexity of the negotiations and subject matter render it quite meaningless in practice.

The EP is much more closely involved in EU rule-making; through co-decision, it has real power. However, it has its own shortcomings. First, it has a pro-integration bias: while it may be open to different ideas of what European policy should be, it is unlikely to conclude that there should be no, or only weak, EU policy in a particular field. Second, European politics plays a subordinate role in European parliamentary elections, where national issues dominate. The EP thus does not accurately represent the EU-relevant opinions of EU citizens. Third, and maybe most importantly, the complexity of financial market regulation and the vagueness of policy goals (market efficiency, ‘levelling the playing field’, investor protection, etc.) make MEPs even more dependent on outside expertise than the European Commission. MEPs will not always be able to tell the difference between firms’ disinterested expertise and strategic lobbying.

The technocratization of capital market governance, mainly through the involvement of CESR, has further institutionalized a particular vision of what are legitimate policy goals and how they can best be attained. For example, CESR members take investor protection seriously and see it as a legitimate goal of public policy. In contrast, it is considered illegitimate, if not outright ridiculous, to use financial market regulation to shield corporations from hostile takeovers. It would constitute the kind of ‘political interventionism’ technocratic policy is meant to prevent.

The institutionalization of supranational technocratic governance compromises the democratic legitimacy of capital market policy. Policy goals that do not fall within a narrow vision of what financial regulation should do—increase market efficiency, including the promotion of investor protection—are systematically excluded, regardless of whether they reflect the authentic preferences of EU citizens or not.

From a democratic perspective, the most worrying aspect of current arrangements is not that financial firms try to influence policy in their own favour. What is more worrying is that these attempts are not balanced by the interests of other stakeholders, and that the resulting pre-

eminence of banks remains largely invisible from the outside. The first step towards improving legitimacy in the field is thus a better understanding of how financial market governance works in the EU, and how it has become what it is today.

Methodological considerations

The aim of this thesis is to identify the ‘prime dynamics’ (Rosenau 1986) behind the supranationalization of EU capital market governance. In the most general sense, the thesis only covers a single case. On this level, comparative tools such as those suggested by King et al. (1994) will not be available to ‘test’ the argument. This difficulty results from the question at the core of the thesis. If, as argued here, a complex structuration dynamic best explains the shift in capital market governance, it makes little sense to carve up social reality into segments that individually might be more amenable to comparison and ‘testing’. Established theories—of financial liberalization, European integration, comparative political economy, institutional dynamics, etc.—cannot by themselves account for the variation we are interested in. With an exclusive focus on any one of them, the big picture is lost.

The dissertation’s approach to corroboration therefore builds on several strategies. The approach advanced here, it is claimed, explains supranationalization better than alternative approaches, such as theories that build on conceptions of national interest, the public good and the pressures emanating from financial globalization. For example, some EU scholars have argued that the European Commission has been the driving force behind EU financial market integration (Posner 2005, cf. Gottwald 2005). This thesis shows that while (highly visible) Commission support was an important condition for integration, it was not a sufficient one—after all, the Commission had been in favour of integration all along. Rather, the core variation that explains integration over time has been the political support of the financial industry and firms’ ability to form successful alliances with key public actors. This is not to say that competition politics can account for every detail in the political process. The emphasis on structuration creates room for irregularities *within the theory advanced here*. In fact, competition

politics not only allows for such irregularities—it expects them, due to the conceptual pre-eminence of political agency over macro-level processes.

Such ‘congruence methods’ (George and Bennett 2005: 181ff) compare the empirical evidence against the predictions of (rival) theories. They can make valuable contributions, particularly as the theoretical framework here generates predictions over numerous units of analysis: the preference formation and political strategies of firms, preference aggregation through state apparatuses, the political salience of particular issues due to their impact on the competitive landscape, etc. For all these ‘intervening variables’, this thesis can find variation within the sub-cases of its larger case. Most obviously, there is variation over time. This includes the explanandum of the thesis—the supranationalization of capital market governance—and other shifts over time—firm interests and market structures—that form part of the explanation. There is also variation between countries, notably between the three discussed in detail: Germany, France and the United Kingdom. Their political institutions, market structures and industry interests differ, and these explain variation in their positions on market integration. There is also variation between firms: large firms with international operations have different interests from small, domestic ones. In the early 1990s, universal banks’ preferences differed from those of securities houses; a decade later, investment banks’ positions differed from those of stock exchanges.

The study also uses ad hoc comparisons to strengthen the argument at crucial points (cf. Gerring 2007). Most of these concern comparisons with other, related sectors. The trajectory within capital markets is particularly surprising when compared to banking, where early agreement was easy and little happened in ensuing years. At the same time, comparison of the MiFID with the clearing and settlement sub-sector shows that even with the new institutions in place, transnational agreement on rules cannot be reached so long as competitive issues in the industry remain unresolved.

Both the time-frame this thesis covers and the theoretical approach which underlies it call

for a variety of sources. A great deal of research has already been done on the period up to the mid-1990s. This study draws on both the empirical material assembled in that literature and its analytical insights. These include academic publications in the narrow sense, as well as publications of international organizations, public bodies and think tanks such as the OECD, the European Central Bank and the Centre for European Policy Studies.

In addition, this thesis' subject has been covered in the specialized financial press over the past two decades. The *Financial Times* and *The Economist*, for example, provide a wealth of factual information on market developments. More specialized publications such as *The Banker*, *Euromoney*, *European Banker* and the *Financial Regulation Report* supply valuable background information, for example on political negotiations. They also provide a level of detail that academic publications rarely achieve.

Filtered by the preferences of private and public actors, market trends and developments are central to explaining changes in governance institutions. The 'market-side' of the empirical argument draws considerably on quantitative data. There are, however, limits to the usefulness of such data for this study. While statistics on macro market developments such as stock market indices are widely available, reliable time series statistics on trade in financial services, let alone investment banking, are difficult to obtain. Because financial firms use different methods for reporting their activities, finding common yardsticks for quantifying the relative importance of their foreign business, for example, is difficult. Where possible, figures on variables relevant to this study are used to assess the strength of the argument, for example trends in industry change. But these do not lend themselves to statistical procedures such as multivariate regression analysis. The quality of available statistics and their usefulness will be further discussed in chapter 5, where their potential to contribute to analysis is greatest.

Unsurprisingly, the scholarly literature on EU capital market governance is relatively thin on developments in the past decade. Here, much information can be gleaned from policy documents in which the European Union is awash, including draft directives, consultative

documents and the responses it gets from such consultations. Governments make their positions known through press releases and the speeches of its public officials. Industry associations also publish a wealth of material. The language used in these publications often requires a thorough understanding of the subject to discern political positions in the midst of technical jargon. But especially when compared, these documents often betray the political position of their authors.

At the same time, the theoretical approach of this thesis points to a better understanding of political *processes* as a core element of explaining political and market change. The aim is to go beyond demonstrating variation in key variables—market structures, political institutions, industry preferences, lobbying efforts, etc.—and to show empirically how they are connected and feed into each other. Through the use of ‘process tracing’ methods (Bennett and George 2005: 6), the ambition is not reveal not only causal *effects*, but also causal *mechanisms* (Gerring 2007: 37ff). The sources listed thus far provide only limited insights in this regard, certainly with respect to the more recent events covered in chapters 6 through 8. This gap has been filled with over 50 unstructured in-depth interviews with policymakers and financial market insiders. Because of the dearth of scholarly literature about the episodes they cover, those three chapters also provide more empirical depth than their predecessors.

The interviews for this research were conducted in Brussels, London, Frankfurt, Paris, Bonn, Berlin and The Hague (for an overview of those interviews actually referenced in this thesis, see the table at the end of this thesis). Respondents included Commission representatives, MEPs, the EU-embassies of central member states, CESR, the most important lobbying organisations⁴, public officials in France, Germany and the UK, lobbyists of individual (investment) banks and exchanges and a member of the Lamfalussy Committee. The role of respondents as informants explains the unstructured character of the interviews: ex ante, it was

⁴ These included the London Investment Banking Association, the European Banking Federation, the European Savings Banks Group, the International Capital Market Association, Association Française des Entreprises d’Investissement, the Future and Options Association, the British Bankers Association, the Bundesverband deutscher Banken, the Federation of European Securities Exchanges, the European Securitisation Forum, the Investment Management Association and Association of Private Client Investment Managers and Stockbrokers.

often impossible to determine on which specific issue a respondent would have and be willing to share most relevant information, and to maximise their usefulness, interviews had to be kept highly flexible.

Many of the issues discussed are politically sensitive. To allow respondents to be frank and forthcoming with information, the interviews were generally conducted under Chatham House Rules: content can be quoted, but only in a way that does not reveal the identity of the respondent. A number of interviews were not recorded but reconstructed directly after the conversations on the basis of detailed notes. The concomitant loss in data reliability was compensated by a presumed higher readiness of respondents to speak freely, share relevant information and hence by a stronger internal validity of this study's findings. Because the capital markets policy community is small—its core comprises no more than 150 people who generally know each other—respondents' concrete identities remain opaque in most citations.

Overview of the thesis

After chapter 2 has detailed the theoretical foundations of the study, chapter 3 presents the domestic side of the international constellation. It shows how the institutional power of domestic market incumbents in Germany, France and the UK brought them privileged access to government policy. It also shows how competition politics *within* national markets was central to regulatory reform and the 1980s wave of financial liberalization. Liberalization was not enforced against the interests of powerful domestic banks, but with their backing. Liberalization was not about 'freeing' markets and introducing more competition, but remaking markets in line with changing domestic political forces.

Chapter 4 analyses the first round of single market negotiations for investment services. It shows how unresolved competitive issues between national financial industries were the main obstacle to the kind of swift and encompassing agreement that emerged in the field of banking proper. The constellation of competitive interests in EU capital markets—essentially a

fragmentation along national borders—made national governments the main public actors in EU negotiations. The Commission, and its wish for deeper integration, was effectively sidelined.

Chapter 5 shows how the market side of the international constellation changed over the course of the 1990s. Many national market incumbents developed transnational business ambitions; large continental banks that had hitherto relied largely on their credit businesses re-oriented themselves towards investment banking. This reorientation was no simple ‘adaptation’ to cross-border market integration or to ‘globalization pressures’—banks actively sought out new business opportunities and internationalized capital markets in the process. Market integration in the 1990s moreover built upon the regulatory changes agreed since the mid-1980s—which the banks themselves had backed.

Chapter 6 shows how a pro-integration consensus—and a sense of being in the same boat—emerged among the large firms active in Europe. Leading investment banks started designating lobbyists especially for European affairs and intensified their links with supranational bodies, which now emerged as their natural public sector allies in the quest for deeper integration. Semi-formal contacts between the Commission and leading industry players—most conspicuously through the Financial Services Strategy Review Group—led to the Financial Services Action Plan (FSAP), a ‘to-do list’ for the completion of the single financial market, the first draft of which was published by the Commission in 1998. A concerted effort by this transnational public-private alliance to convince national governments of the worthiness of this initiative led to EU member states endorsing it in 1999.

Once the EU legislative programme had been agreed, institutional change emerged on the political agenda. Whereas national control over domestic regulation and market access had previously trumped rule harmonization and market integration, the balance now reversed. Chapter 7 recounts the installation of supranational and technocratic governance as a ‘remedy’ to ‘political interventionism’ in EU capital market decision-making. Industry representatives lobbied for governance arrangements that would both match emerging transnational market structures

and accord them maximum influence. With the adoption of the Lamfalussy process, two new supranational committees were installed—the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). Especially the latter has altered the way in which EU capital markets are governed.

Rounding off the empirical body of this thesis, chapter 8 explores these new patterns of governance ‘in action’. As part of the FSAP programme, the ISD was renegotiated and eventually replaced by the Markets in Financial Instruments Directive (MiFID). Supranational bodies and transnational industry associations were now the key players—a far cry from the days when governments and national financial industries faced off in negotiations for the ISD. The MiFID negotiations, however, revealed that with the coming of supranational governance, competition politics had anything but disappeared. MiFID negotiations pitted transnational public-private alliances against each other, most notably large investment banks against stock exchanges. As a prime example of market structuration, this chapter demonstrates how demutualization—a strategic decision made by banks as owners of stock exchanges—fed back into market governance and thus the contemporary regulatory regime. The final section of this chapter shows how in the case of clearing and settlement, continued industry fragmentation frustrated Commission attempts to introduce supranational rules. The competitive interests of financial firms still prevailed.