The State, the Market and the Rule of Law
A Restatement

Katharina Pistor

INET Annual Conference
Hong Kong, April 2013

State and market are often depicted as distinct, even antagonistic. Markets appear as natural products of spontaneous ordering; states as leviathans that if left untamed will distort, if not destroy markets' natural state. The rule of law shall ensure that everyone plays by the rules of the game. A rule bound State corrects for market failure, but goes no further; rule-observant market actors operate within the constraints the rule of law imposes on them.

Consider an alternative image of how state, market and the rule of law relate to one another: Financial markets are legally constructed. State law has transformed relational finance into large-scale market-based financial systems. The specific configuration of contemporary global finance has made markets' survival in the last instance dependent on discretionary rather than rule bound state action. This is eroding the rule of law, the legitimacy of the state and confidence in markets.

Two assumptions separate these contrasting images – uncertainty and liquidity volatility. If assumed away, the first image is plausible; when taken seriously the second trumps. My reading of the empirical evidence is that there is better support for the latter "dialectic" scenario.

This dialectic scenario requires a conceptual shift from unidirectional to iterative relations between and capable of changing the relation between as well as the very nature of the state, the market, and the rule of law. This essay will illustrate this by showing how law has constructed global financial markets, how financial markets in turn have become dependent on the state and the actions states have taken to rescue markets erode the rule of law.

The Legal Construction of Global Financial Markets

Credit and finance date back millennia. People have borrowed from one another in coin or kind to afford extraordinary expenses (weddings, funerals, etc.) or to meet their obligations when facing liquidity shortage. Modern financial markets are of a different kind. Market participants source funds from multiple sources to make bets on an inherently unknown future. Law has helped broaden the funding base by allowing parties to breach traditional spheres of exchange and to rely on (the shadow of) coercive law enforcement.

Nation states created the requisite legal mechanisms for financial markets first at the national and subsequently at the international level. Law was standardized – in codes and nation-wide case reports – and court systems were organized to ensure the consistent application of the law. The standardization of contract law in private practice and the harmonization of state law in key areas related to finance have created a “level playing field” for financial intermediaries. Parties can choose the forum where their disputes shall be resolved and international treaties have extended the coercive powers of court enforcement to awards rendered by foreign or international arbitral awards.[1]

Apart from state issued money every financial asset is a creature of contract law. The ability to choose the law that shall govern one’s contract has been critical for the rise of cross-border finance. The parties to a contract can choose the national law that shall govern their contract whether or not either of them has any direct relation to that legal system and courts and arbitral tribunals will respect this choice. This principle has been extended from contracts to financial assets – contrary to the long held view that the location of property shall determine the applicable law. Instead, for securities or financial assets the parties can determine that location contractually.[2] This has allowed global financial intermediaries to shop for the law most amenable to innovative financial assets, yet trade them globally.

Choice of law and forum go a long way in facilitating market integration. For *financial* market integration, however, more was needed: the liberalization of capital accounts and the standardization of prudential regulation for financial

[1] Not, though, as a general matter to court rulings or regulatory actions.

[2] Technically this is done by determining the jurisdiction of the issuer (which needs not be its actual location); see Art. 8-110 UCC for the US.

intermediaries. Only once states had relinquished control over the kinds and volume of financial assets that crossed their borders did financial markets become scalable globally. The right of legal persons to freely move across borders further supported this trend. Natural persons require visas to cross national borders; not legal persons. Under the General Agreement for Trades and Services, financial intermediaries are free to set up shop almost anywhere. This does not insulate them from the laws and regulations of foreign states, but they must be treated like nationals and no worse than other foreign legal entities.

Moreover, the standardization of prudential rules has leveled the regulatory playing field. The Basel Committee of Banking Supervisors (BCBS), a group of national banking supervisors from self-appointed countries – formerly the G7, now the G20 – has standardized prudential regulation for banks. It has also created rules for allocating supervisory and emergency responsibilities for international intermediaries among national regulators. These home-host guidelines provide that foreign branches remain under the authority of the parent bank's home regulator while foreign subsidiaries (i.e. independent legal entities owned by the parent) are subject to that country's regulation and supervision. For purposes of consolidated supervision of the entire group, including foreign branches and subsidiaries, the parent banks' supervisor is in charge.

This legal patchwork allows financial intermediaries to choose the jurisdiction most permissible for their operation, to create new financial assets and scale them to global markets – all this while still benefiting from the shadow of coercive enforcement only states can offer. Further, the division of labor between home and host countries allows parent bank operations (and their regulators) to outsource liquidity and insolvency risks to foreign countries and their taxpayers. Different choices could have been made in the legal construction of the global financial system. Importantly, global financial markets would not exist were it not for this or similar legal bedrock; and once created a legal bedrock is sticky and thus difficult to change.

States and the Socialization of Markets

If markets operated as suggested in the first scenario the creation of a legal and regulatory playing field should have produced efficient outcomes. The legal interventions outlined freed markets from unnecessary constraints, reduced transaction costs and information asymmetries. As such they were not market constructing, but market liberating.

In fact, the opposite outcome has ensued: the “enabling” law has made markets exceedingly dependent on the state. This is the case, because uncertainty and liquidity volatility render markets inherently instable. Market participants have incentives to shift the risk of uncertainty and liquidity volatility to others. The more freedom they have to do so and the more sophisticated the financial and legal engineering, the more instable the system becomes. Specifically, financial engineering has allowed contractual parties to split different risks associated with financial products and allocate them to different agents; they have also eveloped new insurance products to cover their back. Yet, neither uncertainty nor liquidity volatility can be purged from the system. In deed, in a financial crisis the enforcement of these contracts can hasten the system's collapse.[3]

In the last instance only a state can save the system from self-destruction. The market mechanism rests on the premise that private entities face "hard" budget constraints. They innovate, compete, destruct and create, because if they don't they will be outcompeted and may face extinction. The law re-enforces this principle by mandating bankruptcy for entities that experience insolvency; many entities are exited from the market or reorganized before being given a second change. In principle this applies to financial intermediaries as well, but not to all and not always. Not to all, because of the fear that taking out a large or highly interconnected intermediary might bring down the entire system; and not always, because the same outcome would ensure should too many intermediaries be declared insolvent.

Better regulation should make financial intermediaries more resilient to crises; but financial crises cannot be eliminated. In a competitive system, actors will always seek new strategies to outcompete their peers and the legally constructed global financial system offers them many ways to do so. They can seek out their favored jurisdictions for relocation or issuance of new financial products, shift the default risk to contracting parties or subsidiaries, or devise new types of

[3] See my companion paper on "The Law-Finance Paradox" submitted for this conference.

intermediaries that fall through the cracks of existing regulation. The amount of regulatory coordination needed to prevent this is too great and politically too difficult to achieve. If crisis prevention is impossible, there will always have to be an ultimate backstop: entity with unlimited recourse to high-powered money. If private entities are characterized by hard, and public entities by soft budget constraints, then this entity can by definition only be a state.

Not every state can offer last resort backstopping. Only states that control their own currency and issue most of their debt in that currency do. Seeking proximity to the global backstop thus becomes a matter of survival; not surprisingly the concentration of financial centers in proximity to ultimate backstops – the C5 -- has increased over time.

The dependence on the state has altered markets, the state and the state-market interplay. Last resort backstops are caught in a spiral from which it is difficult to escape: they backstop the financial system by lowering interest rates, offering liquidity and bailing out selective intermediaries to avoid collapse. Yet these actions alter the system they wish to maintain. They signal that in the last instance the private actors' survival constraint is determined not by their ability to succeed in the market place, but to destroy it. To prevent this outcome the state has effectively socialized the market.

Sacrificing the Rule of Law

The law is a double-edged sword in dialectic scenario: critical for creating and scaling markets globally, but in direct tension with the States' backstopping operations. By rescuing financial intermediaries from imminent distinction or offering liquidity where no liquidity is owed, the state – or the central bank as its agent -- effectively suspends the operation of the law. Even if it does not explicitly breach existing contracts, it undermines the foundations they rest on; and even if central banks do not explicitly violate legal constraints placed on them, the discretionary powers they exercise undermines their status as un-political institutions. Indeed, central banks have employed their powers to intervene highly unevenly. To limit their interventions to what was necessary they have focused their efforts on the system's core. The periphery has been left to run its legally predetermined course – the contractual mechanisms, collateral enforcement and bankruptcy rules designed to enforce hard budget constraints.

This outcome violates the principle of the rule of law. It tweaks the rules of the game for some, but not for everyone and thereby signals that not everybody is equal before the law. Interventions of this kind may be tolerable for the rule of law if they occur rarely; systemic violations are not; and repeat interaction that shape future expectations transform the system. This is not only a problem of moral hazard; it questions the legitimacy of the state, the market, and the rule of law.

References:

Frydman, Roman, and Michael D. Goldberg. 2011. *Beyond Mechanical Markets: Asset Price Swings, Risk, and the Role of the State*. Princeton: Princeton University Press.

Guzzini, Stefano. 2011. "Relational Power." In *Encyclopedia of Power*, edited by Keith Dowding, 564-568. Tousand Oaks, CA: SAGE.

Helleiner, Eric, and Stefano Pagliari. 2011. "The End of an Era in International Financial Regulation? A Postcrisis Research Agenda." *International Organization* no. 75 (Winter):169-200.

Hodgson, Geoffrey M. 2013. "Some Comments on "The Legal Constitution of Finance" by Katharina Pistor." *This Issue*.

Kaletsky, Anatole. 2010. *Capitalism 4.0*. New York: Public Affairs.

Keynes, John Maynard. 1964 (1936). *The General Theory of Employment, Interest and Money*. Orlando, Florida: Harcourt, Inc.

Mehrling, Perry. 2011. *The New Lombard Street: How the Fed Became the Dealer of Last Resort*. Princeton Princeton University Press.

Minsky, Hyman P. 1986. *Stabilizing an Unstable Economy*. New Haven: Yale University Press.

Pistor, Katharina. 2013. "A Legal Theory of Finance " *Journal of Comparative Economics* no. 41 (2).

Tilly, Charles. 1985. "War Making and State Making as Organized Crime." In *Bringing the State Back In*, edited by Peter Evans, Dieter Rueschemeyer and Theda Skocpol, 169-191. Cambridge: Cambridge University Press.