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Between Public and Private

Heterarchy in an Age of Intangibles and Financialization

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2.1 INTRODUCTION

In the twenty-first century, world politics is becoming increasingly multi-nodal and characterized by heterarchy, namely the predominance of cross-cutting sectoral mini- and meso-hierarchies above, below, and cutting across states.

In this context, states are becoming "reactive states" as their capacity for "pro-active" policymaking and implementation are eroded. This process is leading to an uneven spectrum of market/hierarchy or public/private de facto policymaking processes and diverse types of "capture" between a range of private actors and meso- and micro-hierarchies, institutions, and processes. The result is the decreasing capacity of macro-states to control both domestic and transnational political/economic processes. At the same time, global regulation is increasingly fragmented, whipsawed between transnational and subnational private special interest groups, leading to potential crises at a complex range of nodes and levels.

The core of this process is the triangulation of (a) the "disaggregated state,"[1] (b) fragmented global governance and "regime complexes,"[2] and (c) "sectoral (or functional) differentiation" in the international political economy.[3] Functional differentiation, which is organized around economic sectors with different "asset structures,"[4] increasingly cuts across state borders, enmeshing both state and non-state structures and actors in what have been called "third-level games" – political, economic, and social – that transform the nature of the state itself. What new forms

[1] A. M. Slaughter, *A New World Order* (2004).

[2] K. J. Alter and K. Raustiala, The Rise of International Regime Complexity (2018) 14 *Annual Review of Law and Social Science* 2, at 21.

[3] P. G. Cerny, Functional Differentiation, Globalisation and the New Transnational Neopluralism, in *Bringing Sociology into International Relations: World Politics as Differentiation Theory* (A. Mathias, Ba. Buzan, and M. Zurn eds., , 2013), 205–227.

[4] O. E. Williamson, *Markets and Hierarchies* (1975); O. E. Williamson, *The Economic Institutions of Capitalism* (1985).

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of functional differentiation might evolve at global/transnational levels? Global governance (the transnational "political sector")? Domination by a transnational capitalist class or global markets (the transnational "economic sector")? Global civil society – or an amorphous "neomedievalism" or "durable disorder"?[5]

It can be argued that economic factors came to be the most significant variable in the consolidation of nation-states. The first industrial revolution transformed the United Kingdom into the first economic superpower. This led other protostates to consolidate in competition with other emerging states on both levels, especially in Europe, where the nation-state system developed and spread its organizational model internationally through innovation, trade, and empire.[6] More important historically, however, was the second industrial revolution, in which the combination of the consolidation of nation-states and the large factory system in a range of cutting-edge industries led to new forms of international competition.

These developments, both market-based and monopolistic/oligopolistic, gave rise to hierarchically organized state-economic complexes and, indeed, to social and institutional reorganization along the interacting lines of capitalist hierarchies and Weberian bureaucratization. The state, therefore, has nevertheless been seen as centripetal in the evolution of economic and socio-political life[7]. This conceptualization of the state has been dominated not only by empirical state-building processes themselves but also by the perception among mass publics that states, despite their disadvantages, are normatively the best way to organize political life. Furthermore, state-building has long been associated at least since the Enlightenment with notions of progress and modernity, whether liberal, capitalist, or socialist. Debates about the relations between business and politics have centered on this problematic.[8] In the twenty-first-century world, however, the capacity of states to effectively regulate the world political economy is being eroded from above, below, and cutting across borders. Regulatory authorities are increasingly characterized by private sector–dominated institutions and processes, especially in the financial sector.

2.1.1 *Beyond State-Centrism: The Dialectic of Globalization and Fragmentation*

A range of diverse governance processes are increasingly integrated into complex, heterogenous ways to other interactive, overlapping, and/or competing processes

[5] P. G. Cerny, Neomedievalism, Civil War and the New Security Dilemma: Globalisation as Durable Disorder (1998) 1 *Civil Wars* 1, at 36–64.

[6] P. Kennedy, *The Rise and Fall of the Great Powers* (1988).

[7] P. Birnbaum, *La logique de l'État* (1982).

[8] P. G. Cerny, *The Changing Architecture of Politics: Structure, Agency and the Future of the State* (1990).

and institutions – what we elsewhere call "heterarchy."[9] Furthermore, globalization itself is all too often perceived to be a structurally homogenizing process, requiring new forms of intergovernmental cooperation or global governance. Dimensions of homogenization are said to include economic globalization, the ideological hegemony of neoliberalism,[10] socio-cultural convergence, technological innovation and change, liberal internationalism and global governance, and the emergence of a particular kind of so-called flat world.[11] Normative calls for a world state follow this logic – so-called global governance.

Therefore, in a world that is increasingly characterized by complex interdependence, states, domestic political systems, and public policymaking are vulnerable to cross-cutting and intersecting independent variables they cannot control. In the structural environment of the third (and/or fourth) industrial revolution(s),[12] and the complex forces undermining neoliberal globalization and the state, whether ideological, social, or material, there is also a trend toward developing diverse forms of neoliberalism from the quasi-democratic to the authoritarian.[13]

This structural transformation revolves around the interaction of fundamental technological transformations and the interrelationships of business and politics in an ever-evolving dialectic of globalization and fragmentation.[14] These transformations involve a wide range of economic processes that include information and communications technologies (ICT), new forms of research and development (R&D), the shift of investment from expensive and hierarchical production processes to profit-making through distribution and the embedding of a consumer culture, artificial intelligence, digitalization, the advent of Big Data, the increasing use of algorithms,[15] robotics, the growing vulnerability of labor processes and their replacement by flexibilization of diverse kinds,[16] and the transformation of finance to "financial alchemy," including increasing dependence on debt and leverage or credit. The businesses that adapt successfully to these changes are crucial in shaping the relations between business and the "reactive state."

[9] R. Belmonte and P. G. Cerny Heterarchy: Toward Paradigm Shift in World Politics (2021) 14 *Journal of Political Power* 1.
[10] P. G. Cerny, *From Theory to Practice: The Paradox of Neoliberal Hegemony in 21st Century World Politics*, in *Theory as Ideology in International Relations: The Politics of Knowledge* (B. Martill and S. Schindler eds., 2020), 140–164.
[11] T. L. Friedman, *The World Is Flat: A Brief History of the 21st Century* (2005).
[12] J. Rifkin, *The Third Industrial Revolution: How Lateral Power Is Transforming Energy, the Economy, and the World* (2011); K. Schwab, *The Fourth Industrial Revolution* (2016); J. Haskel and S. Westlake, *Capitalism without Capital: The Rise of the Intangible Economy* (2018).
[13] Cerny, *supra* note 10.
[14] P. G. Cerny and A. Prichard, The New Anarchy: Globalisation and Fragmentation in 21st Century World Politics 2017 13 *Journal of International Political Theory* 3, at 378–394.
[15] D. Gritsenko and M. Wood, Algorithmic Governance: A Modes of Governance Approach (2020) *Regulation and Governance*, doi:10.1111/rego.12367.
[16] L. Gratton, *The Shift: The Future of Work Is Already Here* (2011).

Political agency is therefore no longer defined by interest groups seeking out the levers of state power, because these levers are seen to be largely impotent or politically suspect.[17] Related to this turn from the state is "deterritorialization" or the "poverty of territorialism."[18] Structural homogeneity between state and society in specific geographical/territorial locations, crucial to the unitary coherence of the nation-state, is being undermined by cross-border linkages.[19] In particular, the kind of strong, secure borders that are supposed to characterize the sovereign nation-state are becoming impossibly porous and in many cases more analogous to fluid, premodern "frontiers."[20] The increasing complexity of this system raises questions about whether this complexity will lead to endemic conflict or a "durable disorder" in which key actors are engaged in various forms of "brokerage" to smooth over the underlying dysfunctionality of the system.

One way to conceptualize these processes is thinking of them in terms of the kind of ongoing process that Rosenau calls "fragmegration"[21] – the dialectic of globalization and fragmentation in a "postinternationalist" world. The European Union, for example, is in continual structural quasi-crisis, trying to deal centrally with plural tensions between the local and the transnational dimensions. Indeed, the United States has always been characterized by internal socioeconomic division.[22] Furthermore, austerity and the erosion of the rights of labor are undermining the mid-twentieth-century social contract on which the welfare state and liberal democracy have been based.[23] Political leaders in unstable states are either engaged in attempting to restore authoritarian repression, as in Russia, China, Egypt, and Turkey, or are ensnared in the breakdown of the political system, as in Brazil, Venezuela, and a range of African countries, leading the emergence of quasi-authoritarian populism, including what has been called "personalist autocracy."[24]

Rationalities of marginal utility have transformed statehood itself into a marketizing, commodifying process[25]. Furthermore, the state has itself become a promoter

[17] J. Holloway, *Change the World without Taking Power: The Meaning of Revolution Today* (2002).

[18] A. Faludi, *The Poverty of Territorialism: A Neo-Medieval View of Europe and European Planning* (2018).

[19] J. A. Scholte, *Globalization: A Critical Introduction* (2000).

[20] P. De Wilde et al. (eds.), *The Struggle over Borders: Cosmopolitanism and Communitarianism* (2019).

[21] J. Rosenau, The Governance of Fragmegration: Neither a World Republic Nor a Global Interstate System, paper presented at the World Congress of the International Political Science Association, Quebec City, August 1–5, 1990.

[22] C. Woodward, *American Nations: A History of the Eleven Rival Regional Cultures of North America* (2011).

[23] M. Blyth, *Austerity: The History of a Dangerous Idea* (2013).

[24] T. Frye, Russia's Weak Strongman: The Perilous Bargains That Keep Putin in Power (May 23, 2021) *Foreign Affairs*, www.foreignaffairs.com/articles/russia-fsu/2021-04-01/vladimir-putin-russias-weak-strongman.

[25] Cerny, *supra* note 10.

of financialization rather than welfare or social democracy, prompting the financialization of society itself – replacing decommodifying welfare and public services through austerity and undermining the potential for what has been called the "entrepreneurial state" concerned with providing public goods.[26] Nevertheless, the state continues to be the primary provider of welfare programs, and finance cannot do without it either, for a host of public goods rely on finance for credit.

Actors develop and maintain particular institutions and structures over time. Society and polity shape our interactions through people and material processes that connect them.[27] They take place through our interactions with the computers, logistics, and groups of people "next" to us in an increasingly intangible world of "capitalism without capital."[28] The process is itself nonlinear and causally complex.[29] For example, actors and political processes can only react to price changes that are independently produced by market and institutional transactions, many of which are increasingly automated, and certain sectors like communications and social media require further regulation. What governance levels would be necessary for such regulation? Would it be effective? The United States and the European Union are dealing with this question through different and contrasting approaches, with the European Union paradoxically taking a more comprehensive and centralized approach with one main regulator, whereas the United States has maintained its divided regulatory system among a range of sectorally specific regulatory bodies.

Furthermore, actors' social positioning shapes their range of possible responses to material processes in multi-nodal fashion[30]. For example, information and communications technologies that circle the globe also create the potential for backlashes of diverse kinds as awareness of global-level problems, inequalities, and instabilities spreads through our everyday practices. Indeed, business actors are sometimes not only captured by preexisting state-based structures and practices but paradoxically also see them as valid reactions to globalization and transnationalization – what Bohas and Morley call

[26] Y. Tiberghien, *Entrepreneurial States: Reforming Corporate Governance in France, Japan, and Korea* (2007); F. Block and M. R. Keller, *State of Innovation: The U.S. Government's Role in Technology Innovation* (2011); M. Mazzucato, *The Entrepreneurial State: Debunking Public vs. Private Sector Myths* (2013); A. Herman, *Freedom's Forge: How American Business Produced Victory in World War II* (2012).

[27] N. Srnicek, Representing Complexity: The Material Construction of World Politics, PhD thesis, London School of Economics and Political Science, 2013; D. H. Coole and S. Frost, *New Materialisms: Ontology, Agency, and Politics* (2010).

[28] Haskel and Westlake, *supra* note 12.

[29] P. T. Jackson and D. H. Nexon, Relations before States: Substance, Process and the Study of World Politics (1999) 5:3 *European Journal of International Relations* 291; E. Cudworth and S. Hobden, *Posthuman International Relations: Complexity, Ecologism and Global Politics* (2011); A. Prichard, Collective Intentionality, Complex Pluralism and the Problem of Anarchy (2017) 13 *Journal of International Political Theory* 3, at 360–377.

[30] P. G. Cerny, Multi-nodal Politics: Globalisation Is What Actors Make of It (2009) 35:2 *Review of International Studies* 421.

an "anomic mindset."[31] The dialectic of globalization and fragmentation thus decenters the state itself by placing it alongside and competing with other social and economic groups and organizations – rather than above the social and below the international.[32] Strategic actors are able to mobilize resources, ideologies and mindsets, and knowledge to take advantage of the constraints and opportunities and to pursue their interests. This has led to the consolidation of a range of "extra-state authorities"[33] and regime complexes across a range of institutions and processes including "low-capacity states," fragmented global governance and oligopolistic, sectorally differentiated quasi-corporatist policymaking and regulatory and policy implementation processes.

These embed the "privileged position of business"[34] and transnationally powerful interest groups, including intangible sectors such as ICT,[35] banking, and finance, etc., as well as transnational corporations, supply chains, and other linkages transcending and undermining state territorial and economic boundaries. States themselves have sought to benefit from these transformations by sponsoring the competitiveness of domestically located firms, leading to transnational oligopolization and rent-seeking.[36] Paradoxically, the state is not shrinking in size, but the "macro-state" is less and less structurally dominant and bureaucratically effective in the face of these meso-state, micro-state, and trans-state apparatuses.

Crucial in this restructuration process are a range of private sector–dominated regulatory agencies. For example, in the derivatives market – the "world's biggest

[31] A. Bohas and M. Morley, Revealing the Anomic Mindset: Discontent of International Managers and Their Detours on the Pathway toward the Development of a Global Mindset, Academy of Management Annual Meeting Proceedings (2020), DOI:10.5465/AMBPP.2020.20240abstract.

[32] Prichard, *supra* note 28.

[33] R. Belmonte, Political power in a heterarchical world. A categorization of Extra-state authorities, in Heterarchy in world politics (P.G. Cerny eds, 2022), 80–92.

[34] C. E. Lindblom, *Politics and Markets: The World's Political-Economic Systems* (1977); C. E. Lindblom, *The Market System: What It Is, How It Works, and What to Make of It* (2001).

[35] F. Fukuyama et al., How to Save Democracy from Technology: Ending Big Tech's Information Monopoly (2021) 100 (January/February) *Foreign Affairs* 98; P. Delimatsis, The Resilience of Private Authority in Times of Crisis: A Theory of Free-Riding of Private Ordering, The Evolution of Transnational Private Rule-Makers: Understanding Drivers and Dynamics, Conference at Tilburg University, Tilburg Law and Economics Centre (TILEC) December 3–4, 2021. See S. Bijlmakers, The International Organisation for Standardisation: A 75-year Journey towards Organisational resilience, The Evolution of Transnational Private Rule-Makers: Understanding Drivers and Dynamics, Conference at Tilburg University, Tilburg Law and Economics Centre (TILEC) December 3–4, 2021; P. Hugues Verdier, Resilience and Change in Private Standard-Setting: The Case of LIBOR, The Evolution of Transnational Private Rule-Makers: Understanding Drivers and Dynamics, Conference at Tilburg University, Tilburg Law and Economics Centre (TILEC) December 3–4, 2021; and J. Reinecke, The Politics of Collaborative Governance in Global Supply Chains: Power and Pushback in the Bangladesh Accord, The Evolution of Transnational Private Rule-Makers: Understanding Drivers and Dynamics, Conference at Tilburg University, Tilburg Law and Economics Centre (TILEC) December 3–4, 2021.

[36] P. G. Cerny, Paradoxes of the Competition State: The Dynamics of Political Globalization (1997) 32:2 *Government and Opposition* 251.

market" – regulation is provided by such bodies as the International Swaps and Derivatives Association (ISDA), central counterparties (CCPs), trade repositories (TRs), and other bodies dominated by "dealer banks" (the G16), which do not constrain speculative trading, ignoring "calls for bans on derivatives products that were particularly associated with destabilizing speculative trading such as 'unattached' (or 'naked') CDS contracts [credit default swaps] in which the purchaser does not hold the underlying bond to which the contract is linked."[37] In other words, the only form of regulation that it is possible to institutionalize is dominated by private sector firms and actors. Recent history suggests that the development of an effective global governance structure as a way to reorganize world politics is increasingly unlikely, even moving in the opposite direction.[38] Biermann et al.[39] refer to the "fragmentation of global governance architectures" as the dominant trend in the twenty-first century.

In this context, the globalization/fragmentation dialectic opens up those processes to precisely the kind of special interests that have been identified in the long-standing critical domestic interest group, elitist, corporatist, and neopluralist literature of the twentieth century[40]. And the proliferating literature on multinational corporations and transnational production chains, the advances of information and communications technologies, and, in particular, the power of quasi-globalized financial markets and institutions[41] demonstrates that global governance itself can be even more vulnerable to whipsawing, bypassing, capture and manipulation, even corruption, than the traditional domestic public policy sphere. Lindblom[42] refers to this as "the privileged position of business".

At the core of these processes, furthermore, is the hybridization of the public and the private. Key actors – the more powerful economic interest groups, state actors in particular issue areas, certain NGOs, etc. – have differing and sometimes conflicting interests. In this heterarchical political process, actors depend upon the capacities of real-world, cross-cutting "interest" groups – including both "sectional" (or "material interest") and "value" groups,[43] civil society groups, NGOs, and social movements – to manipulate constraints, to identify and take advantage of opportunities, and to

[37] The definitive source here is E. Helleiner, S. Pagliari, and I. Spagna (eds.), *Governing the World's Greatest Market: The Politics of Derivatives Regulation after the 2008 Crisis* (2018); the quote is from p. 7, but this theme dominates all the subsequent chapters about specific derivatives markets.

[38] P. G. Cerny, The Limits of Global Governance: Transnational Neopluralism in a Complex World, in *Partnerships in International Policymaking: Civil Society and Public Institutions in European and Global Affairs* (R. Marchetti ed., 2016), 31–47.

[39] F. Biermann (ed.), *International Organizations in Global Environmental Governance* (2009).

[40] P. G. Cerny, *Rethinking World Politics: A Theory of Transnational Neopluralism* (2010).

[41] P. G. Cerny, Rethinking Financial Regulation: Risk, Club Goods and Regulatory Fatigue, in *Handbook of the International Political Economy of Monetary Relations* (T. Oatley and W. Kindred Winecoff eds., 2014), 343–363.

[42] Lindblom, *supra* note 33.

[43] V. O. Key Jr., *Politics, Parties, and Pressure Groups* (1953).

shape new directions through processes of competition, coalition-building, "forum shopping," or "venue shopping" and the like. What is new, however, are the rapidly evolving transnational linkages among groups in a growing range of overlapping transnational webs of power. The most important movers and shakers are no longer simply domestic political forces, institutions, and processes but transnationalizing ones: whether in terms of economic interdependence; social interconnections, migration, the movement of people, and transnational awareness through world communications and social media; relationships of violence and force (including terrorism); "transgovernmental networks" cutting across governments themselves; problem-solving "epistemic communities";[44] technological change from the Internet to a growing variety of human activities; ideological conflict and competition; and a whole range of other deep trends.

Governance itself is therefore being transformed into a "polycentric" or "multinucleated" global political system operating within the same geographical space – and/or overlapping spaces – in ways analogous to the emergence of coexisting and overlapping functional authorities in metropolitan areas and subnational regions.[45] In the economic sphere, post-Fordist forms of production based on flexibilization have transformed "techniques of industry," labor markets, finance, and the like, thus leading to a "capitalism without capital."[46] The particular shape a transformed international system is likely to take will be determined primarily by whether particular sets of groups[47] that are able to exploit the structural resources or political opportunity structures available to them take advantage most effectively in a period of structural flux.

Key sets of groups that have in the past been closely bound up with the territorial nation-state and state actors themselves are increasingly captured instead by transnational sectors. These actors do not merely set state agencies and international regimes against each other – a process sometimes called "venue shopping," "forum

[44] P. Haas, Knowledge, Power, and International Policy Coordination (1992) 46 *International Organization* 1.

[45] V. Ostrom et al., The Organization of Government in Metropolitan Areas: A Theoretical Inquiry (1961) 55:3 *American Political Science Review* 831. P. Delimatsis, The Resilience of Private Authority in Times of Crisis: A Theory of Free-Riding of Private Ordering, The Evolution of Transnational Private Rule-Makers: Understanding Drivers and Dynamics (Conference at Tilburg University, Tilburg Law and Economics Centre (TILEC) December 3–4, 2021). See O. Kanevskaia, and J. Baron, Global Rivalry over the Leadership in ICT Standardisation: SDO Governance Amid Changing Patterns of Participation, The Evolution of Transnational Private Rule-Makers: Understanding Drivers and Dynamics (Conference at Tilburg University, Tilburg Law and Economics Centre (TILEC) December 3–4, 2021.

[46] Haskel and Westlake, *supra* note 12; C. B. Frey, *The Technology Trap: Capital, Labor and Power in the Age of Automation* (2019).

[47] R. M. Kanter, *The Change Masters: Innovation and Entrepreneurship in the American Corporation* (1985).

shopping," or "regulatory arbitrage."[48] They also cause them to try to network in an increasingly dense fashion with their peers in other states and simultaneously instill them and their transnational private/public links in state elites too. Among the major losers are trade unions and other groups with few transnational linkages and less clout in an intangible economy where labor has become more "flexible" and, indeed, "commodified," although they are sometimes still in a position to obtain compensatory side payments from national governments.

Operating in such a changing world is leading to new problems of management and control, what Lake has called "the privatization of governance"[49] and others have identified as the emergence of "private authority" in international affairs. Private actors decide the rules of their conduct and act to ensure order in the markets, facilitate trade, and protect private property.[50] Institutions and formal processes of global governance do not have the direct sanctioning power that has been at the core of state development in the modern era – especially in the form of Weber's "monopoly of legitimate violence." In the meantime, the sovereignty of states is only partially and unevenly pooled through the development of intergovernmental institutions and processes – what authors often refer to as the concept of "soft law."[51]

Significant issue areas, including accountancy, auditing, and corporate governance, have witnessed ongoing negotiation processes among firms; private sector organizations representing particular industrial, financial, and commercial sectors; as well as governments and international regimes, in order to reconcile conflicting standards and move toward a more level playing field. Also, decision-making processes related to many significant issues moved from elective arenas to places presented as politically neutral with the consequence of a loss of political character of such issues and the annihilation of divergences and conflicts within the field of political actions.[52] Consequently, it is becoming more and more difficult to organize

48 A. Kellow, Multi-level and Multi-arena Governance: The Limits of Integration and the Possibilities of Forum Shopping (2002) 12 *International Environmental Agreements* 327; H. Murphy and A. Kellow, Forum Shopping in Global Governance: Understanding States, Business and NGOs in Multiple Arenas' (2013), 4:2 *Global Policy* 139.

49 D. A. Lake, Global Governance: A Relational Contracting Approach, in *Globalization and Governance* (A. Prakash and J. A. Hart eds., 1999), 31–53; M. Kahler and D. A. Lake (eds.), *Governance in a Global Economy: Political Authority in Transition* (2003).

50 A. Cutler et al. (eds.), *Private Authority and International Affairs* (1999); K. Ronit and V. Schneider (eds.), *Private Organisations in Global Politics* (2000); R. B. Hall and T. J. Biersteker (eds.), *The Emergence of Private Authority in Global Governance* (2003); E. P. Stringham, *Private Governance: Creating Order in Economic and Social Life Oxford* (2015).

51 A. L. Newman and E. Posner, *Voluntary Disruptions: International Soft Law, Finance, and Power* (2018).

52 M. Flinders and M. Wood, Depoliticisation, Governance and the State (2014) 42:2 *Policy and Politics* 135; R. Belmonte and M. Damiani, The Depoliticization of Immigration: Youngsters and Immigrants in Perugia, in *Changing Democracies in an Unequal Word* (F. Saccà ed., 2021), 88–105.

politically effective resistance to globalization as such, especially in the more developed capitalist states, although recent examples of the growth of populism on both right and left has been at the forefront of recent politics.

Furthermore, in an era where states compete to attract foreign direct investment, transnational corporations can make strategic actions independently of the interests of the countries in which they operate. Also, they have an increasing role in law-making processes that they exercise through lobbying activities. Often, they turn to practices of self-regulation, private governance, risk management, and alternative dispute resolution.[53] Their resources come from private sources – even if governments very often support transnational corporations (TNCs) through public investments and favorable tax conditions[54] – and are used to earn profits for a restricted circle of actors that in most cases are involved in private decision-making processes. At the same time, transnational financial agencies operate in several economic-financial fields, including the insurance, accountancy, and risk management sector, affecting the allocation of resources between social groups, national economies, and commercial enterprises.[55] Indeed, they assume an institutional role consisting in ensuring trust among participants in economic-financial transactions[56].

2.1.2 *Sectoral Differentiation*

In this context, different sectors at different levels and organizational structures play differentially powerful roles in this process. Analysts including Gordon,[57] Piketty,[58] and Stiglitz[59] have argued that the third and fourth industrial revolutions have reduced the profitability of the real economy, leaving capitalists fewer alternatives to financial manipulation to gain income and wealth compared to the second industrial revolution era,[60] leading to growing inequality and economic instability.[61] This process, combined with the increased capacity of transnationally linked financial special interests and pressure groups to lobby and capture state and international policymaking agencies and processes, leads to an uneven heterarchy of the kind we

[53] Stringham, *supra* note 48.
[54] Mazzucato, *supra* note 25; Cerny, *supra* note 35.
[55] S. Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (1996); A. Pizzorno, Natura della disuguaglianza, potere politico e potere privato nella società in via di globalizzazione (2001) 62 *Stato e mercato* 201; Stringham, *supra* note 48.
[56] Pizzorno, *supra* note 52.
[57] R. J. Gordon, *The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War* (2016).
[58] T. Piketty, *Capital in the Twenty-First Century* (2014).
[59] J. E. Stiglitz, *People, Power, and Profits: Progressive Capitalism in an Age of Discontent* (2019).
[60] A. Gemzik-Salwach and K. Opolski (eds.), *Financialization and the Economy* (2017); T. Bayoumi, *Unfinished Business: The Unexplored Causes of the Financial Crisis and the Lessons Yet to Be Learned* (2017).
[61] A. Faiola, How Debt is Making Global Inequality Worse, *The Washington Post*, Today's Worldview, November 19, 2021.

have elsewhere labeled "transnational neopluralism."[62] Also, this process includes reorganizing political institutions, realigning political forces and coalitions, reforming policy processes, and restructuring ideological space, thus reinventing the social dimension of politics through new policy and coalition "spaces" populated by a wide range of new and old political actors in both the developed and developing worlds.

These new political processes are therefore differentiated more by sector and issue area than by physical, geographical, or territorial space. They involve a combination of vertical, horizontal, and diagonal restructuring of institutions and policy domains. In purely economic terms, this means that firms with extensive specific assets are more efficiently organized through quasi-monopolistic, hierarchical governance structures.[63] The key dimension here concerns the configuration of interests, characteristic of the industry, or activity concerned. There are essentially two aspects of this dimension: the mobility of physical capital and cross-border price sensitivity.

In firms and sectors that are highly integrated or linked into such structures and processes, especially where there is a "world market price" for a good or asset that determines local prices, lobbying pressure from firms in that sector and from industry organizations is likely to be organized through flexible "pentangles" (coalitions that include transnational actors from outside the national "container" and which operate at the transnational level to influence global governance processes) rather than simpler iron triangles.[64] The politics of key issue areas like financial regulation can play a catalytic role in reshaping global economics and politics as a whole, imposing their particular market and policy structures on other sectors and issue areas too.

2.1.3 *Finance and Politics in the Twenty-First Century*

Finance plays a unique role in the processes outlined above, and financialization is a key independent variable in the structuration of business-politics relations over the past half century. Unlike the "real economy", finance is the ultimate intangible sector, because it links and shapes all the others. On the one hand, economic and social progress have required the development of finance and money to grow. In this sense, finance and politics can be seen to be mutually interdependent, with effective policymaking requiring support for the development and institutionalization of finance in order to pursue wider social and political goals and to develop systemically relevant structures and processes, both macroeconomic and microeconomic. Without finance, whether private or public, there would be no economic development. On the other hand, however, the creation of financial instruments and the

62 Cerny, *supra* note 38.
63 Williamson, *supra* note 4 (both).
64 P. G. Cerny, From "Iron Triangles" to "Golden Pentangles"? Globalizing the Policy Process (2001) 7:4 *Global Governance* 397.

evolution of financial markets in a range of circumstances can permit finance to become autonomous from the real economy and to develop a dynamic of its own.

However, the contemporary evolution of finance and money since the middle to late twentieth century is unique in history. We will examine three distinct but inextricably intertwined trends and variables that are shaping the relationship of politics and finance today. Together they are making finance more independent, opaque, and disconnected from the real economy than ever.

The first of these structural trends is the restructuring of the world political economy around the transnationalization of special financial interests. The second is the structuration of the financial sector itself through the development of a range of complex financial instruments, especially securitization and derivatives, which disconnect finance from the real economy and therefore from political and social objectives. The third trend involves the wider political context and impact of government and transnational regulation of finance.

This leads to various attempts by the "reactive state" and overlapping and competing transnational "regime complexes" to manage the workings of the financial system in ways that support that system and its market mechanisms. These attempts not only led to the Global Financial Crisis (GFC) of 2007–2008 but also have continued in its aftermath.[65] In this context, we will consider a range of crucial social and political consequences of what has been called "financialization."[66] The evolution of the world political economy is widely seen as increasingly problematic and dysfunctional as a result.[67] The role of finance in the world economy has been evolving in the general direction of financialization since the 1950s.[68] There have been several factors driving this process:

- growing trade and pressures on the international system to reallocate capital across borders as a result, with the postwar financial system becoming more flexible and extensive;
- domestic budgetary and other pressures on the postwar welfare state, leading to policies of budgetary belt-tightening and to neoliberal economic policies across various levels and sectors;
- leveraging – of the role of debt – in both the domestic and the international financial systems, including the ideology of "financial inclusion";

[65] B. S. Bernanke et al., *Firefighting: The Financial Crisis and Its Lessons* (2019).

[66] Gemzik-Solwach and Opolski, *supra* note 58.

[67] For an authoritative analysis, see M. Sawyer, Financialisation and the Dysfunctional Nature of the Financial System, in *Progressive Post-Keynesian Economics: Dealing with Reality* (J. Jespersen and F. Olesen eds., 2019), 69–85.

[68] This section draws on a wide range of sources, but in particular: B. Christophers, *Banking across Boundaries: Placing Finance in Capitalism* (2013); R. Faroohar, *Makers and Takers: The Rise of Finance and the Fall of American Business* (2016); A. Nesvetailova, *Fragile Finance: Debt, Speculation and Crisis in the Age of Global Credit* (2007); R. Guttman, *Finance-Led Capitalism: Shadow Banking, Re-regulation and the Future of Global Markets* (2016).

- and the predominance of new financial instruments and institutions like securitization and "shadow banking," which will be examined more closely in Section 2.1.4.

In the post–World War II period, the internationalization of banks and the increasing flow of financial assets across borders led to pressures for significant structural changes in the international financial system. Most writers focus on the emergence of the Eurodollar market in the 1950s and 1960s, in which a combination of international pressures and the role of domestic institutions – originally involving the Midland Bank in the United Kingdom – led to increasing regulatory tolerance for American financial assets, especially those obtained outside the United States, to be deposited in the United Kingdom, outside the scope of US regulations. This process encouraged and reinforced increasing cross-border financial flows in general, augmented politically as well as financially by the tradition of sterling as an international currency and the historical role of the City of London as an international financial center. In this context, financial firms and institutions developed strategies consistent with the wider process of globalization. Indeed, transnational finance has often been identified as the key independent variable driving globalization.[69]

Furthermore, one of the approaches that several important authors have taken is to apply the theories of Hyman Minsky.[70] He argued that financial crises are endemic in capitalism because periods of economic prosperity encouraged borrowers and lenders to be progressively reckless. This excess optimism creates financial bubbles and the later busts. Therefore, capitalism is prone to move from periods of financial stability to instability. This is a type of market failure and needs government regulation. It is the flexibility, complexity, and opacity of finance that gives it its strength and significance in controlling and coping with political and bureaucratic processes such as regulation and, in particular, crisis management, especially in the context of the "Great Recession" of the mid and late 2000s.

2.1.4 *The Development of Financial Instruments and Institutions*

As financial flows expanded in the postwar period and virtually exploded in the 1980s and 1990s and since, financial firms and actors sought to devise new ways of trading on increasingly complex financial markets, moving away from traditional trading

[69] Strange, *supra* note 53; S. Strange, *States and Markets* (1988); P. G. Cerny, Globalization and the Changing Logic of Collective Action (1995) 49:4 *International Organization* 595; P. G. Cerny, *Finance and World Politics: Markets, Regimes and States in the Post-Hegemonic Era* (1993).

[70] A. Minsky and P. Hyman, *Can "It" Happen Again?: Essays on Instability and Finance* (1982); A. Minsky and P. Hyman, *Stabilizing and Unstable Economy* (1986).

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processes and structures including established stock and securities markets. This trend required several developments in the nature of the tradable instruments. The first was flexibility – the ability to trade an increasing range of instruments in a growing array institutional and noninstitutional public and private markets and informal quasi-market networks. The second involved the "tradability" of those instruments, namely their widespread acceptance and use in an interconnected range of settings from the local to the global. The third involved widening the range of financial market actors, from financial firms themselves to households and individuals, which has been called "financial inclusion" or "the financialization of daily life."[71] The fourth has been the restructuring of the overarching financial industry itself into fewer and fewer "SIFIs" – systemically important financial institutions, both controlling the overall process and strengthening special relationships with regulators.[72] The fifth required the extremely rapid expansion of leverage to finance these developments, rather than redistributing profits or assets from the real economy.[73] The sixth has been the doctrine of "shareholder value" capitalism, in which the first priority of all firms is the making of profits that are transferred to shareholders rather than reinvested in a real economy firm's production and exchange processes that include labor and other "stakeholders."[74] The final development, probably the most controversial, has been said to be the consolidation of a new form of rentier capitalism, in which profits are skimmed off by financial elites, impeding rather than enabling growth in the wider economy and leading to increasing inequality.[75] This final trend is also sometimes said to enable and entrench illegal activities and the rigging of economic and financial outcomes, what Veblen called "sabotage."[76] As the result of this set of developments, Sawyer argues that the twenty-first-century financial system is "dysfunctional."[77]

The financial instruments at the core of the process are not technically new but have been dramatically expanded in the context described above. They mainly involve "securitization" and "derivatives." Traditional banks, both commercial and investment, operated on the basis of what has been called "originate-to-hold." In both cases, those banks keep the financial instruments they deal with on their books. In contrast, what have been called "non-bank" financial firms and institutions restructure and sell the instruments they originally "own" in a range of formal and

71 R. Martin, *Financialization of Daily Life* (2002).

72 A. R. Sorkin and R. Andrew, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System from Crisis – and Themselves* (2009).

73 D. Graeber, *Debt: The First 5,000 Years* (2011); T. Di Muzio and R. H. Robbins, *Debt as Power* (2016).

74 L. Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (2012).

75 E. Fullbrook and J. Morgan (eds.), *The Inequality Crisis* (2020).

76 A. Nesvetailova and R. Palan, *Sabotage: The Business of Finance* (2020).

77 M. Sawyer, *Financialization and Economic and Social Performance*, in Gemzik-Salwach and Opolski, *supra* note 58, 9–25; Sawyer, *supra* note 64.

informal financial markets. They transform them into new kinds of securities in a process known as "securitization" and the value of those securities comes from the prices they attract as well as their salability in various formal and informal markets.[78] Derivatives, in turn, are securities the value of which does not derive from the original securities themselves but from their being based on the market value of these securities themselves when bought and sold. They are, in effect, insurance policies on the prices and market value of the securities from which they are "derived."[79]

Securitization is a complex process in which the original securities themselves are "sliced and diced" into "tranches," namely segments created from a pool of securities that are divvied up by risk, time to maturity, or other characteristics in order to be marketable to different investors. Each tranche of a securitized or structured product is one of several related securities offered at the same time but with varying risks, rewards, and maturities to appeal to a diverse range of investors. Different tranches will have different credit ratings, appealing to different buyers with senior tranches for the highest and safest credit ratings, junior tranches for the riskiest ratings, and mezzanine tranches for a generally small intermediate category. Typical investors of senior tranches tend to be conduits, insurance companies, pension funds, and other risk-averse investors. Junior tranches are more risky investments because they are not secured by specific assets. The natural buyers of these securities tend to be hedge funds and other investors seeking higher risk/return profiles.

Tranches allow for the "ability to create one or more classes of securities whose rating is higher than the average rating of the underlying collateral asset pool or to generate rated securities from a pool of unrated assets."[80] This is accomplished through the use of credit support specified within the transaction structure to create securities with different risk-return profiles. The equity/first-loss or junior tranche absorbs initial losses, followed by the mezzanine tranches, which absorb some additional losses, again followed by more senior tranches. Thus, due to the credit support resulting from tranching, "the most senior claims are expected to be insulated – except in particularly adverse circumstances – from default risk of the underlying asset pool through the absorption of losses by the more junior claims."[81] Some tranches are sold and traded separately and some as parts of single, combined securities.

[78] This process is widely covered in the literature, but this section draws, in particular, on M. Zandi, *Financial Shock: A 360° Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis* (2009); cf. Helleiner, Pagliari, and Spagna, *supra* note 37.

[79] See Helleiner, Pagliari, and Spagna, *supra* note 37.

[80] I. Fender and J. Mitchell, Structured Finance: Complexity, Risk and the Use of Ratings (2005) 3:1 *Financial Stability Review* 127.

[81] Committee on the Global Financial System, January 2005.

Virtually the whole political economy literature on securitization and derivatives discusses their complexity, opacity, and disconnectedness from the real economy. However, in the context of the free market, neoliberal and deregulatory ideology of national governments, and transnational regime complexes[82], such financial instruments and processes are still treated lightly and warily by both policymakers and regulators. A crucial part of these developments is the transformation of the financial institutional infrastructure itself. Increasingly important over time is the restructuring in recent years of banking and other financial institutions and markets and the macrofinancial and microfinancial structural shifts involved, adapting ways of doing things from the "shadow" sector in order to compete.

The highly institutionalized commercial and investment banks described above have historically been the core of traditional financial systems and until recently have been highly regulated and insured by governments in order to underpin the stability of the system as a whole. This was particularly true of the US Emergency Banking Act of 1933, which divided up commercial and investment banking and administered them separately. In particular, the act set up the Federal Deposit Insurance Corporation to underpin the commercial banking sector, insuring deposits originally of $2,500, increased over the years to six deposits in different accounts of $250,000, for a total of $1,500,000 in 2011. While these banks are still propped up by the US Government, they have increasingly had to compete with what PIMCO (Pacific Investment Management Company) executive director Paul McCulley at a FED (Federal Reserve System) annual meeting in 2007 called "shadow banks."

Nesvetailova provides a useful definition of the difference:

> While, for instance, traditional banks are assumed to be taking in short-term deposits and converting them into long-term loans, shadow banks do the opposite: they take in long-term savings (e.g. pension fund liabilities) and transform them into short-term savings. If traditional banks take in liquid deposits (e.g. cash and similar instruments) and transform them into less liquid securities, shadow banks do the opposite: through a combination of financial and legal operations they transform illiquid assets (such as mortgages or car loans) into apparently liquid financial securities.[83]

In other words, shadow banks have not only used securitization and derivatives to make greater profits than is available in traditional banking but indeed have triggered a system-wide change in the nature of finance. The authors cited in this chapter and many others have noted that the way shadow banks have done business over recent decades has forced the reconstruction of traditional banks too. In order to compete, other institutions have to jump on the bandwagon because

[82] N. Barofsky, *Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street* (2012).
[83] A. Nesvetailova (eds.), *Shadow Banking: Scope, Origins and Theories* (2018).

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that's where the money increasingly goes, creating "long and opaque chains of credit intermediation."[84]

This is particularly true of what are called "universal banks," which originate consumer and corporate loans, package loans into asset-backed securities (one of the major dimensions of the securitization process) and what are called "collateralized debt obligations" (CDOs), create over-the-counter (OTC) derivatives whose value are derived from loans, and distribute the resulting securities and other financial instruments to investors. Furthermore, complex financial institutions have used the OTC strategy to maximize their fee income to reduce their capital charges and to transfer the risks associated with securitized loans to investors. Other structural shifts include the setting up of Special Purpose Vehicles (SPVs), Structured Investment Vehicles (SIVS), and other nonregulated, quasi-independent institutions in which to park, especially less profitable or endangered securities the markets for which have slowed or shut down. Regulated banks in effect become shadow banks because they had to restructure and become opaquer and complex in order to compete.[85]

A major consequence of rise and dominance of shadow banking therefore concerns the shift of investing from cash and investment in the real economy to the circulation of the purely financial instruments described above. For example, pension funds have grown dramatically as the result of the shift from defined benefit to defined contribution pensions (the result of the declining power of labor unions in the real economy), along with money market mutual funds (MMMFs), hedge funds, etc.[86] Thus, there are two tendencies: the accelerating pace of financial innovation and the capture of monopoly-like rents through "'shrouding,' or embracing complexity."[87] In other words, growing demand for profitable investment increasingly creates more and more supply because of and facilitated by the abstract nature of finance itself.[88]

The future of governance of the financial system has not been resolved and some argue the concerns may be growing and intensifying as regulatory stopgaps unravel. All national governments and regional organizations such as the European Union have considered and even attempted to implement a range of regulatory changes in the financial sector, and all of these have been critically scrutinized and found wanting. Furthermore, the Dodd-Frank Act of 2010 in the United States has been seen as in some ways counterproductive because of (a) maintaining competing regulatory bodies (in the United States) that have different approaches, (b) leaving

[84] Nesvetailova, *supra* note 79.

[85] Ibid.

[86] P. Coggan, *Guide to Hedge Funds: What They Are, What They Do, Their Risks, Their Advantages* (2010); S. Lack, *The Hedge Fund Miracle: The Illusion of Big Money and Why It's Too Good to Be True* (2012).

[87] Nesvetailova, *supra* note 79.

[88] D. Gabor, Shadow Connections: The Hierarchies of Collateral in Shadow Banking, in Nesvetailova, *supra* note 79, 143–162.

actual regulation-making to these bodies in the future, resulting in partiality and whipsawing, (c) insufficient transnational convergence,[89] and (d) limitations on the capacity of the Financial Stability Oversight Council (FSOC) to create policy consistency. Indeed, The Trump Administration engineered a partial rollback of Dodd-Frank in 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act. Finance is the hegemonic sector in the structural transformation of the simultaneously globalizing and fragmenting intangible economy.

2.2 CONCLUSIONS

A central debate in the business and politics issue area is whether the growing significance of intangibles in the real economy, along with nonproductive financialization and regulatory arbitrage are (a) crowding out investment in the real economy; (b) whether the "intangible" economy is itself creating new forms of monopolization that do not require the kinds of financial investment characteristic of the nation-state–supported second industrial revolution; (c) leading to greater inequality and political backlashes such as populism;[90] (d) creating a growing level of over-indebtedness and leverage, from real economy firms to financial firms that will lead to chronic Minskyian crises; and (e) whether nation-state governments are limited to "firefighting" and "bailouts" to salvage national financial systems – that is, the "reactive state" rather than the "proactive state."

The future of business and politics as the twenty-first century unfolds is thus potentially unstable and increasingly procyclical, with various levels of uneven heterarchical quasi-governance lacking the institutional capacity to shape the system as a public good. While the contributors to this volume show that private actors can exert a positive influence, they also give us reasons to be skeptical about private actors' ability to deliver public goods. In the context of banking and finance, various authors have diverse partial policy prescriptions. For example, D'Arista[91] argues that financial institutions need stress tests to be based on cash reserves rather than capital requirements; Guttmann[92] argues for revising the International Monetary Fund's Special Drawing Rights and giving them a greater international role; and Roos[93] argues for the greater use of debt default to tackle overleveraging, especially of sovereign debt. Nesvetailova and Palan[94] argue that "sabotage" will ultimately be necessary to tame Minskyian tendencies. However, as the proverb goes (variously

89 Helleiner, Pagliari, and Spagna, *supra* note 37; Gemzik-Solwach and Opolski, *supra* note 58.

90 M. Sawyer, Financialisation, Financial Crisis and Inequality, in *Inequality: Trends, Causes, Consequences, Relevant Policies* (P. Arestis and M. Sawyer eds., 2018), 43–88.

91 J. D'Arista, *All Fall Down* (2019).

92 R. Guttman, *Finance-Led Capitalism: Shadow Banking, Re-regulation and the Future of Global Markets* (2016).

93 J. Roos, *Why Not Default? The Political Economy of Sovereign Debt* (2019).

94 Nesvetailova and Palan, *supra* note 73.

attributed to at least two dozen people, from Niels Bohr and Yogi Berra to Woody Allen and Confucius): "Prediction is difficult, especially about the future." The unevenness and complexity of the rapidly evolving system of heterarchy in world political economy is laying the groundwork for future crises at multiple overlapping and interacting levels as the reactive state becomes more and more ineffective at regulating finance – and other sectors – in a "postinternationalist" world.