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# Controlling the Locusts: Germany and the Global Governance of New Financial Markets

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**Controlling the Locusts:  
Germany and the Global Governance of New Financial Markets**

By

**Hubert Zimmermann**

**Abstract**

In April 2005, during the national election campaign in Germany, the Chairman of the German Social Democratic Party, Franz Müntefering, likened private equity firms and hedge funds to swarms of locusts sucking out firms and laying off employees. His remarks were among the shrillest in an increasingly intense international debate on the better regulation of international financial markets. New forms of private capital have amassed such huge amounts of financial resources that state regulators not only in Germany increasingly fear risks for global financial stability. However, Germany is particularly active in this regard. During its presidency of the G-8 in 2007, Germany has made the tighter regulation of global financial industries one of its core objectives.

These initiatives lead directly into some of the core controversies of the literature on global economic governance: what is the extent of state capacity in regulating global financial markets, which forms of regulation are achieved, and what are the theoretical instruments allowing us to explain cooperation and non-cooperation among states and between states and private actors? This paper looks at the reasons and prospects of Global Economic Governance initiatives under the new financial (non)architecture, using Germany as empirical example

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## Preface

This paper was presented during a conference on 'Germany in Global Economic Governance', which took place at Cornell University on Feb. 22/23, 2008. It was organized by Stefan Schirm (Ruhr University of Bochum) and Hubert Zimmermann (Cornell). We would like to thank our sponsors, the DAAD (German Academic Exchange Service), the Department of Government, the University of Bochum, the Mario Einaudi Center for International Studies, the Institute for European Studies as well as Peter Katzenstein (Cornell), who served as commentator.

Germany, still the third or fourth largest global economy, has been particularly active in proposing a tighter regulation of international financial markets. We use Germany as an exemplary case of how medium-sized countries can shape global governance and how the political economy of countries with coordinated market economies conditions their global governance strategies as compared to so-called liberal market economies, such as the United States and the United Kingdom. With this focus, the project permits and initiates an overdue dialogue between the literatures on varieties of capitalism and on global governance, using global governance as the dependent variable. Another objective of the workshop was to address the dearth of country-specific case studies in research on global governance which often treats all states as essentially similar in their reaction to economic globalization.

Contributors were asked to look at various areas of global governance (such as hedge fund regulation, IMF reform, Basel II, pharmaceutical regulation, corporate governance, transgovernmental standard-setting, etc). All papers identified several levels shaping the German position: the subnational, the European and the global level. The German government, with varying success, engaged in strategic forum-shopping among these levels. A further characteristic was close cooperation between state and non-state actors. Overall, the extent of Germany's capacity to shape global governance is surprisingly large.



## **Controlling the Locusts: Germany and the Global Governance of New Financial Markets**

### **Introduction: Setting Up the Puzzle**

Since the first year of the Schröder administration (1998), when Finance Minister Oskar Lafontaine unsuccessfully called for international cooperation in establishing target zones for the world's leading currencies (Wolf 2006: 200-1), a rather inconsistent but fairly continuous stream of initiatives on global economic governance (GEG) has been pronounced by German government officials. The common denominator of these proposals has been intensified cooperation among the major economic powers to achieve a more efficient regulation of global markets. Though Germany did not suffer too much in the financial crises from the mid-1990s and during the more spectacular failures of the unfettered capitalism of the last decade,<sup>1</sup> these German efforts did not abate with the end of the Red-Green Schröder coalition. In the past two years, the Merkel government has been very productive in this respect, arguing in various international and European settings for tighter rules on hedge funds and private equity investors, a fundamental reform of the ways in which rating agencies operate, defensive measures against sovereign wealth funds, stricter capital standards for banks, rules on the pay of CEO's and other highly-paid executives in the finance industry, and so on. This conspicuous activity provokes two basic questions:

- 1) What are the causes of these proposals? What makes Germany more activist in this respect than any other member of the G 8?
- 2) What are the results? How big is the capacity of medium-sized states to shape GEG to a noticeable degree? Is Germany a vanguard for the return of the state in global finance or are these proposals part of a rear-guard action?

In this paper, I will concentrate mainly on the first set of questions and make only some general observations regarding the success of Germany's proposals. Overall, the paper seeks to move beyond general GEG concepts which assume similar responses by states to globalization and in that sense also similar positions with respect to global governance.

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<sup>1</sup> With the exception of the recent exposure of some German banks to subprime mortgage assets.

### **Alternative Explanations**

The basic rationalist explanation for GEG sees coordination as emerging from functionalist imperatives which derive from coordination problems in the international system. International institutions reduce uncertainty, provide information, monitor behavior and enable issue linkages (Goldstein 1998: 318). Thus, they stabilize cooperation when the provision of public goods is more effective on the international level, and they help to prevent contagious crises by providing forums for cooperation. Within this perspective, new forms of governance, which include private actors, sometimes exclusively so, have no basically different rationale: they just fulfill these functions more efficiently. These, however, are advantages which benefit all participants in international institutions. Thus, this argument does not explain why some states should be particularly active in this respect. The literature has not moved much beyond the early questions about the conditions for and efficiency of international institutionalized cooperation as well as its various forms, neglecting country-specific factors. And yet, one of the fundamental questions of the contemporary global political economy is the difference between actors preferring little or no institutionalized GEG, be they state or market actors, and other actors emphasizing the benefits of intensified regulation of the global economy.

Another possible alternative explanation for Germany's activism is the constructivist claim which sees Germany's position as shaped by domestic norms of consensual decision-making and public solidarity. These are then transposed to the international level (Schirm 2004: 12-13). This begs the question why Japan and the EU Commission do not enthusiastically join the Germans. In addition, Germany has not hesitated to take unilateral action if this promises positive results. Frequently, among economists and the financial press, another norm-based argument is advanced which claims that the German initiatives reflect an ideologically generated response against Anglo-Saxon liberal markets and a reassertion of a strong state in the German tradition. However, in that case, France should have been noticeably more active in the period under review. Analysts have also pointed to the influence of party politics, in particular the backlash against the Agenda 2000 reforms of former Chancellor Schröder. A broader argument in that sense



has been already advanced by Polanyi (1944: 161-162) who saw diffuse societal forces as the driver behind movements towards regulation. This is also not very convincing given the continuity among the Schröder and Merkel governments and the fact that Germany was not dominated more by leftist parties than other advanced industrial countries.

Realist accounts argue that regulatory competition lies behind many global governance initiatives: states try to export their model to gain and preserve comparative advantages (Drezner 2007). This argument links up with comparativist analyses, in particular the ‘Varieties of Capitalism (VC)’ school, which sees the promotion of international governance rather as a response of political systems to constraints emerging from the imperatives of economic globalization: “...the underlying determinant of a country’s preferences over the structure of multilateralism is the composition of its market economy” (Fioretos 2000: 228). The goal is to preserve domestic arrangements and institutions, and to avoid adjustments – in Germany’s case to the Rhenish model of capitalism. This perspective would argue that in the last decade financial globalization has undermined some particularly cherished facets of German capitalism, such as the close bank-industry nexus, the core role of established banks in raising capital, a long-term outlook on investment, or traditional corporatist decision-making patterns. The promotion of GEG initiatives by Germany might be interpreted as an effort to embed these adjustment processes in a global regulatory framework which limits their consequences and preserves the comparative advantages of the German economy. Such an argument is very attractive because it systematically introduces country-specific variables based on structural characteristics of national economies into the analysis, opening the black box of the state. But it also has some drawbacks. Though Germany’s variety of capitalism certainly had to bear quite its share of adjustment pressures, it arguably was not more afflicted than many other societies. In addition, as Mosley (2003) has shown, only very few indicators of the economic performance of industrial states are actually scrutinized by markets. Many and probably most consequences of financial globalization do not concern them as they impinge not on their ability to deliver public goods. Nonetheless, the argument that Germany’s activism is a defensive reaction against

forced institutional adaptation sounds intuitively convincing and it will be one core hypothesis to be discussed in this paper.

The explanations for Germany's interest in intensified GEG presented up to this point might well contain part of the answer to the initial question of why countries choose to become very active in GEG. However, based on my research up to this point, I claim that Germany's initiatives are primarily neither a result of rational institution-building designed to improve the working of the global economy nor an ideologically motivated response to Anglo-Saxon capitalism nor a conscious attempt to avoid institutional adaptation to recent developments in global financial markets. They are rather motivated by the quest to preserve the legitimacy of political authority presumably under siege by global financial markets. In order to secure their continued allegiance, citizens must perceive the state to meet their expectations (Purcell 2002: 310). This includes protection from threatening aspects of globalization. In this quest for legitimacy, an ad-hoc economic nationalism to protect German firms is frequently employed by political authorities.

A Caveat: In this very preliminary paper I will not reach any conclusive answer. My evidence is as yet not sufficient. It is limited to published documents and an evaluation of the press and literature. I plan to substantiate my claims by interviewing German policymakers from the current and last government and by an analysis of public opinion polls. A fundamental revision of my argument and confirmation of one of the alternative hypotheses is therefore quite possible. This is the beginning of a far larger study which looks at the motivations and effectiveness of the policies of second-tier powers to shape global financial governance in a rapidly changing environment (see also Abdelal 2006).

I will first briefly outline the new situation on global financial markets which provides the background for the recent flurry of German initiatives. This section will concentrate particularly on two phenomena of financial globalization which were the subject of German GEG initiatives, and evaluate their impact on German capitalism: the emergence of hedge funds and private equity as major actors, and the role of rating agencies as core

providers of information for market participants. I will then sketch the details of German activity and discuss the motivations. In a final part I will briefly assess the extent of German influence in shaping GEG.

### **The New Financial (Non-) Architecture**

Not only governments, but also analysts struggle to keep up with the sheer speed of the changes in global financial market. Financial liberalization and technological developments since the end of the Bretton Woods system sparked a wave of financial innovation which completely transformed previously heavily regulated and compartmentalized global financial markets. The increasing withdrawal of states from regulation was partly a cause, partly a consequence of these developments. Basically, the trend was to avoid all intervention apart from necessary rules to avoid potentially contagious financial crises. With that objective in mind, banking regulation moved to the center of regulatory efforts by governments since the mid-1990s, resulting in the Basel I and II agreements of 1988 and 2004, respectively, on capital adequacy standards (Kapstein 2006).

The IMF was charged with a broad surveillance function regarding early signs of risks in the global economy (Pauly 2008). New institutions such as the FSF (Financial Stability Forum) and IOSCO provided additional venues where public officials and private actors would exchange information on possible risks. An increasing number of governance functions, regarding the provision of information and transparency, were devolved exclusively to private actors, such as rating agencies (Porter 2005). Their task was also to improve the transparency of new actors such as hedge funds and private equity firms which became major players in international financial markets since the 1990s. This variable, rather than GEG architecture seemed to work well in recent years, especially in comparison with the turbulent 1990s. The relative calm in financial markets since 9/11 led to a widespread feeling that markets were sufficiently stable, transparent, and consequently self-correcting. The effects of the securitization of debt markets, however, have fundamentally challenged this emerging regulatory network and opened a void which seems to call for completely new answers. Financial innovation and credit creation

now primarily occur outside traditional channels and beyond the reach of state regulation which has neither the instruments, nor the legal competence, and, most crucially, the necessary knowledge to exert control. The result was an increasing reliance by market participants on rating agencies, since buyers of securities have much less information about their debtors than banks which usually have a good knowledge of their customers. This implied also that rating agencies assumed increasingly central roles in global regulation, for example through the use of ratings as benchmarks to calculate capital adequacy ratios for banks in the Basel II capital accord, and through the EU's Capital Requirements Directive (CRD) (Chirico 2008; Kerwer).

The fundamental role of rating agencies was always accepted with unease by continental Europeans, and in the recent crisis their capacity to provide such information turned out to be problematic. In a press conference with French president Sarkozy, Chancellor Merkel strongly denounced this situation: "How can we tell people at home that nobody knew anything about this and yet they all have to live with the consequences?" (Euractiv 2007). The glaring information gap in financial markets could not even be filled by the concerned private actors themselves since these were uncertain about the value of their own investments (Tett/Davies 2007). The result was enormous insecurity once doubts about the value of underlying assets became wide-spread and a corresponding resistance by banks to extend credit in the current crisis turned into a serious problem. Central Banks had to intervene on a massive scale to overcome an unprecedented liquidity crunch. Thus, this crucial new phenomenon, large-scale private credit creation, facilitated by a long period of easy money in the US, still seems to rely on lenders of last resort. Securitisation did not let states off the hook regarding this role, as the cases of Northern Rock or Bear Stearns amply demonstrate. Germany emerged not unscathed either as smaller private and semi-public bank struggled to cover their losses, most notably – until now – West LB, Sachsen LB and IKB. The crises gave a powerful boost to German initiatives for a strengthening of the global financial architecture through an enhancement of intergovernmental cooperation.

The next section will look at German GEG initiatives in detail, and analyse whether they can be interpreted as expressions of a systematic rearguard battle by German capitalism.

### **German GEG Initiatives and the Rhenish Model**

The above mentioned proposals by former Finance Minister Lafontaine in 1998/9 were widely ridiculed and ended in complete failure. In combination with the unsuccessful push to promote its favorite candidate as head of the IMF, this episode seriously dented the confidence of the Schroeder government in shaping GEG (Nunnenkamp 2001; Wolf 2006). However, dissatisfaction with the world financial architecture soon re-emerged, particularly after US and UK based hedge funds forced the two top managers of Deutsche Börse, Rolf Breuer and Werner Seifert, to resign because they did not condone a takeover bid engineered by the two CEOs for the London Stock Exchange. One month earlier, SPD party chairman Franz Müntefering famously had compared hedge funds to 'locusts' stripping German firms of valuable assets for short-term profit. This sparked an intense public debate on new financial investors. Even German bankers called for more regulation of these non-traditional investors (Engelen 2005). The fact that international expansion strategies of a German firm were undercut as a consequence of short-term profit considerations of some shareholders particularly vexed the government. As a result of the Deutsche Börse affair, the German government set up a working group with officials from the finance, economics and justice ministries to look into possibilities for regulating the behavior of hedge funds and private equity firms. The report concluded that national regulation was unlikely to be effective since most of these firms were based abroad (most hedge funds reside for tax reasons in various offshore centers whereas the active management is usually located in London or New York) and recommended the use of international forums, such as the FSF, to tighten surveillance (Engelen 2005).

However, the harsh rhetoric, partly due to the electoral campaign under course, concealed that the Schröder government had not hesitated to sell privatized assets to 'locust' investors and actually had been instrumental in opening the German market to them in 2003 through the so-called investment modernization law (Vitols 2004). Accompanied by changes in the tax code, this law was to reform the bank-based German system of raising

capital, one of the core characteristics of a coordinated market economy (Hall/Soskice 2001).<sup>2</sup> The more short-term oriented profitability motive of hedge funds, in contrast to the longterm strategies of traditional bank-based financial systems, was tolerated by state authorities (Behn 2006). The goal was to enhance Germany's financial competitiveness which was seen as particularly deficient in the area of raising venture capital in high technology industries (Vitols 2004). In addition, the largest German banks increasingly moved away from their traditional core business of exploiting interest differentials between deposits and credits, and moved into more profitable areas such as investment banking (Behn 2006). The Merkel government was also not averse to using the financial clout of private equity investors to reform German capitalism. The Chancellor herself suggested to Blackstone CEO Schwartzman to take a stake in Deutsche Telekom. A FT article argues that the government self-consciously used private equity to push for a restructuring of the company against trade union resistance while it kept a controlling stake and a low public profile during the process (Wiesmann 2007). Such strategic use of the private equity industry lends credence to the constant claims of German policy-makers that their regulatory efforts did not signal a principal disapproval of new financial actors.

Nonetheless, since early 2007, Germany intensified its push for a regulatory code governing the behavior of new financial actors. It went against considerable odds since the US and the UK were decidedly unenthusiastic. Berlin argued that a new regulatory code would reduce systemic risks, enhance investor protection, and preserve market integrity. According to Finance Minister Steinbrück, the short-term outlook of some investors deprived firms of the capacity to pursue long-term strategies, such as investing in research and the training of employees (Interview 2007).

However, the Germans realized the futility of coordinated state regulation at this time and switched tactics. They now argued for a voluntary code by the industry (FT 2007a): "There was a misunderstanding that the Germans wanted to implement some sort of legal regulation. This was never our intention. It was always about sets of standards, codes of

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<sup>2</sup> Examples: Tank & Rast as well as numerous public housing deals.

conduct, guidelines, voluntarily implemented and monitored by the industry itself.” (Steinbrück, quoted in: Benoit and Atkins 2007). Chancellor Merkel personally repeatedly spoke out on the issue and made it one of the topics to be discussed at the G 8 summit in Heiligendamm. This followed her remarks at the Davos World Economic Forum on 24 January 2007, where she revealed her intention to “minimize the international capital market’s systemic risks while increasing their transparency.” She further stated, “Let me make it very clear that I see much room for improvement, especially regarding hedge funds.” Prior to the G 8 summit, the US and the UK quickly voiced their opposition to any statist response to concerns about hedge funds and new forms of investors. In the end, the results of the G 8 summit in this issue were rather meager. However, Merkel stressed that Germany would continue to pursue push the issue during the remainder of its G8 presidency.

At the same time, the government also took notice of the emergence of sovereign wealth funds and began immediately to draw up plans for possible defensive instruments which should work not only against SWFs but also private investors targeting strategic industries (Ambrose Pritchard 2007). These plans were scaled back after the EU Commission demanded that European companies should be excluded (Süddeutsche Zeitung 2008).

While summit meetings had yielded few results, the sudden eruption of the subprime crisis in August 2007 with the resulting dangerous liquidity crunch gave a powerful boost to the Germans. Suddenly, the attention accorded to hedge funds seemed proportionate, as the securitisation of bank loans and the emergence of new investment vehicles, such as derivatives, suggested a new scope of risks. Notwithstanding the Basel II arrangements, it turned out that banks had found ways to offload risks to new vehicles. The insecurity about the value of the more than 10bn\$ asset-backed securities in circulation, with most of these in some ways linked to mortgages and, sometimes, subprime debt, suggested a serious underpricing of risk, facilitated by high ratings which the new investment vehicles had received from rating agencies.<sup>3</sup> This led to a dry-up of interbank lending

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<sup>3</sup> Gillian Tett, Sub-prime in its Context, FT, 19 Nov 2007.

which caused the failure of some banks (including a spectacular run on Northern Rock), huge losses for the big investment banks, and it forced central banks to provide unprecedented amounts of liquidity to help banks stay afloat. As even banks struggled to quantify their losses, the new found opaqueness of markets became glaringly obvious. A flurry of new activity by regulatory agencies and politicians was the result. FSF was charged with preparing a package of measures to enhance transparency in financial markets and to monitor liquidity more closely (FT 2007b).

In late 2007, Merkel, while admitting that the results of the German initiatives had been limited, pledged to renew her push for more state-regulation in an EU framework in case the industry would not come up with credible self-regulation. This signaled a switch of strategy to a stronger emphasis on the European Union. Taking recourse to a frequent pattern, the German government sees its chances for an acceptance of its proposals vastly improved if a prior coordination of the Europeans can be reached, as Thomas Mirow, deputy finance minister, said: ‘An international approach would be much better. If this proves impossible, then we must act at the European level. And if that fails too for political or objective reasons, then we must act nationally’ (quoted in: Benoit 2008). As usual, the German side was first looking for common ground with France. Both Merkel and Sarkozy called for more regulation of hedge funds and rating agencies (Le Monde 2007). A summit of the leaders of Britain, France, Germany and Italy in London on Jan. 29, 2008 was to prepare a common European approach regarding greater transparency in bank liabilities, reforms of credit rating agencies and enhanced cooperation between regulators. However, the summit underlined the divergences between Britain and the other three countries, which argued for a more pro-active approach. Chancellor Merkel emphasized that the important message should be “if you do not comply with this [the need for more transparency and improved rules] then we need to resort to regulatory measures” (Press Conference 2008). The communiqué emphasized the priority of market-led solutions, but also the need for government regulation if such solutions were not achieved rapidly (Communique 2008). Rattled by the near-bankruptcy of the small German bank, IKB, the government has stressed again that voluntary industry-led agreements in some areas might not be sufficient (Benoit 2008).



The European Commission announced it would take a closer look at rating agencies and sovereign wealth funds. The communiqué of the recent EU summit cited as one area of policy action after recent market turmoil a look into ‘market functioning and incentive structure, including the role of credit-rating agencies on which the EU stands ready to consider regulatory alternatives if market participants do not rapidly address these issues’ (Council Conclusion 2008). The results of these initiatives remain to be seen.

More can be said about the motivations. All in all, there are few indications that the German initiatives were based on ideological considerations. In almost all statements, the positive role of a new kind of investors is stressed and both the Merkel and Schroeder government seemed to have taken a rather instrumental attitude towards them. There is also no ‘reflective multilateralism’ at work as Germany seems quite willing to abandon the multilateral track if results can be reached in a different way. The evidence supporting the ‘defense of German capitalism’ argument is decidedly mixed. The German bank-based system with its tight linkages between banks and companies is changing and the linkages have weakened substantially over the past decade as a result of globalization, European regulation, and domestic reforms. Scholars, however, have found that these changes have not amounted to a fundamental transformation of the system but rather to adjustment at the margins (Vitols 2004: 1). The new focus on rating agencies does not support the deesive argument either. While it might suggest that the government is trying to reassert its supervisory role, it should not have taken until the subprime credit crises to push Berlin into action.

The mixed evidence is confirmed by an analysis of recent statements of German policy-makers on these issues. In a programmatic speech in the German parliament on February 15, 2008, Finance Minister Steinbrück discussed financial regulation under the conditions of new financial realities in global markets. The focus of his speech was the decision to bail out IKB with public funds. He cited the imperative to avoid that a German bank should be the first bankruptcy as consequence of subprime crises and the need to prevent a domino effect in the German banking system as justifications (Steinbrück 2008). In his speech he also demanded better international rules and suggested that the balance sheets

of banks should reflect risk better than agreed in Basel II. Again he made clear that if no international agreement was found, Berlin was ready to act unilaterally (Benoit 2008). However, he cautioned against a return to *dirigiste* policies, stressing the positive consequences of global financial markets, and emphasized the various international initiatives pursued by the government. He also emphasized that private or semi-private governance was acceptable as long as it worked efficiently and, crucially, prevented a spillover of financial problems to questions of political legitimacy.

Generally, German governments seem ambiguous about new actors and instruments, partly welcoming them, and sometimes rather indifferent if their autonomy is not constrained (Mosley 2003). In fact, one of the core motivations of recent reforms might have been to reduce the state to exposure of political responsibility for deficiencies in the economic system. What seems to provoke most concern is the fact that the changes in financial markets have made German companies much more vulnerable to hostile take-overs. Whether it is in the very recent debate about defensive measures against sovereign wealth funds or the protection of German companies against hedge funds, economic nationalism appears to be an important motivating factor. However, this suggests not a mercantilist attitude but rather an instrumental strategy to bolster the legitimacy of political authority.

As Streeck and Höpner (2003) maintain: 'The organization of German capitalism was politically motivated. It permitted [the government] to bind market participants into political decision-making and to share responsibility.' In his response to Steinbrück's speech, the CDU Parliamentary Whip, Norbert Röttgen agreed with the Finance Minister that the fundamental problem was the legitimacy problem posed by financial markets and that GEG was the only way to solve this problem.<sup>4</sup> Similar clues for German motivations can also be found in a recent speech of Steinbrück to the financial community in Frankfurt.<sup>5</sup> At length, he stressed the fundamental importance of subjective feelings of

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<sup>4</sup> [www.cducsu.de/Titel\\_Redен/TabID\\_1/SubTabID\\_2/InhaltTypID\\_2/InhaltID\\_8912/Inhalte.aspx](http://www.cducsu.de/Titel_Redен/TabID_1/SubTabID_2/InhaltTypID_2/InhaltID_8912/Inhalte.aspx).

<sup>5</sup> "Gerechtigkeit - Wettbewerbsvorteil in einer globalisierten Wirtschaft", 14 Jan 2008; [www.bundesfinanzministerium.de/cln\\_06/nn\\_2368/DE/Aktuelles/Reden\\_20und\\_20Interviews/076\\_\\_2.html](http://www.bundesfinanzministerium.de/cln_06/nn_2368/DE/Aktuelles/Reden_20und_20Interviews/076__2.html) (acc. 3 Feb 2008).

fairness for the stability of societies. According to him, financial markets depend on this stability and politics has the core role of ensuring fairness in the marketplace, particularly under conditions of financial globalisation. Steinbrück also emphasized the continental tradition of according the state a central role in ensuring equal opportunities for all market participants and added that a widespread feeling of unfairness threatened to rekindle protectionist tendencies and irrational reactions: “We need working institutions, a set of core values, and an efficient, yet not a ‘thick’, state”.<sup>6</sup> Effective global regulation would be the best political response. The message of the importance of effective state capacity as fundamental pillar of political legitimacy was also repeatedly stressed by Angela Merkel in her interventions on the topic. In a speech in late 2007 she said: ‘If we cannot convince people that what we call globalization is manageable, these people will lose their belief in democracy. That is the real danger. Globalisation is man-made. There should not be an impression that it is something like a natural force which cannot be regulated by any political framework’ (Merkel 2007).<sup>7</sup> These statements need to be understood in the context of the legitimacy crises in German politics which was severely deepened by the economic reforms of the Schröder government resulting in the strengthening of new parties, in particular the Left Party.

They allow the following preliminary conclusion: Germany’s stance regarding the economic and institutional impact of new financial phenomena and actors is ambivalent, and the government consciously uses it to force reforms of uncompetitive sectors of the domestic economy and to enhance Germany’s global competitiveness. The plethora of GEG initiatives is primarily motivated by apprehensions regarding the legitimacy of the state. GEG is an instrumental strategy to gain enhanced output-legitimacy.

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<sup>6</sup> Gleichzeitig macht es keinen Sinn, ausschließlich auf die Kräfte des Marktes zu verweisen, denn diese Kräfte können nachweislich nicht alles regeln. Wir brauchen intakte Institutionen, einen Wertekanon und einen handlungsfähigen, keinen fetten Staat.

<sup>7</sup> Wenn Sie nämlich den Menschen nicht den Eindruck vermitteln können, dass das, was wir als Globalisierung bezeichnen, auch gestaltbar ist, dann werden die Menschen den Glauben an die Demokratie verlieren. Das ist die eigentliche Gefahr. Globalisierung ist von Menschen gemacht. Es darf nicht der Eindruck entstehen, sie sei so etwas wie eine Naturgewalt und könne durch keinerlei politischen Ordnungsrahmen gestaltet werden

### **How Successful Were the Germans?**

After the G 8 summit in Germany, it seemed as if Germany's efforts would produce practically no results. However, already in June 2007, the Independent reported that hedge funds started to study voluntary standards, based on the principle 'that it is better to self-regulate than to hang around until the politicians to do it for you'.<sup>8</sup> Haufler (2003: 234) claims that industry self-regulation is usually a defensive reaction to avoid more onerous government reaction. This is exactly what we see as a result of the German initiatives.

In January 2008 London's biggest hedge funds agreed indeed on voluntary standards ostensibly to head off the threat of state regulation (Mackintosh 2008). They had started their initiative already in mid-2007, mainly as a consequence of German pressure, although at that time the German proposals seemed not to go anywhere (Benoit and Mackintosh 2007). As a result of the market turmoil since late 2007, investment banks also increasingly advocate intensified industry self-regulation of new financial vehicles to avoid government regulation (Tett/Larsen 2008). At the same time, within the framework of IOSCO, new rules are being discussed with regard to rating agencies (FT 2008). The EU is discussing the topic intensely and will probably soon reach first results at a ECOFIN meeting in March. Suddenly, Germany's activism seemed to pay off. The evidence suggests even medium-sized countries can be surprisingly efficient in inspiring new forms of regulation. In that sense, Germany might be in the forefront of a Polanyian counter-movement against completely deregulated markets (Polanyi 1944: 132-3).

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<sup>8</sup> The Independent, Hedge funds act to head off the regulators, June 20, 2007.

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