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The legal construction of the global foreign exchange market

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ABSTRACT

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Initial analyses of financial globalization argued that increasing interdependence severely curtailed state authority and policy autonomy. While subsequent research countered such claims, the foreign exchange market, which underpins all cross-border transactions, continued to be characterized largely as operating outside the governance frontier of states. At one level, the qualities of the market lent themselves to such conclusions. Yet, through an analysis of the historical trajectory of two legal instruments, the Treasury Amendment and master netting agreements, the central importance of binding state-enforced explicit and implicit codes, or law, in the foreign exchange market is revealed. Far from operating beyond the reach of states, even this most globalized market is legally constructed. *Journal of Comparative Economics* **41** (2) (2013) 343–354. The Committee on Global Thought at Columbia University, 2960 Broadway, Mail Code 5780, New York, NY 10027, United States.

1. Introduction

Early analyses of globalization argued that massive capital flows, instantaneous financial transactions, and footloose transnational corporations engaging in regulatory arbitrage, resulted in the severe curtailment, if not death, of state authority and policy autonomy. Such "hyperglobalist" proclamations were soon countered by scholars asserting the continued relevance of states in the emergence and functioning of global financial markets. States were not only identified as the authors of liberalization, but also as creators of new rules governing the recently "deregulated" markets. While the state was "reintroduced" into some financial markets, it was curiously absent from the market underpinning all cross-border transactions – foreign exchange. At one level the special position of the global foreign exchange market was not surprising. Trading in this largely electronic space was dispersed around the world and, given its status as an over-the-counter market, was constituted by globe-spanning, individually negotiated bilateral contracts. Many currencies, moreover, had succumbed to assaults mounted by participants in this largest and most liquid global financial market. Given these qualities, it was not a stretch of the imagination to conceptualize the foreign exchange market as unregulated and operating beyond the governance frontier of states.

Despite such features and the image they conjured, other aspects suggested that the global foreign exchange market might be well within the reach of state authority. Besides the trading of national currency instruments and the continual possibility of central bank interventions, the market was characterized by geographic and institutional concentration. During the past 20 years New York and London alone accounted for approximately 50% of total turnover in the market (BIS, 2001, 2004, 2007, 2010), and the highest daily trading activity took place when dealing in both centers overlapped. When the

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remaining five top financial centers were included, the concentration in global turnover increased to 80%. Further countering the dispersed image of this market was the centralization of dealing in about a dozen institutions in each of these dominant financial centers (BIS, 2004 and 2010). These leading firms, moreover, formulated market wide trading practices and policy positions through their involvement in quasi-public organizations, such as the New York-based Foreign Exchange Committee (FXC). Despite the possibility for exchanging a multitude of currencies, moreover, the US dollar was used as one of the "legs" in a majority of trades. Far from being a decentralized electronic space, a core set of geographies and institutions dominated the market.

Such evidence had, however, minimal impact on global foreign exchange market research which largely focused on the factors influencing exchange rate movements. Relegating the state to an external position might simply have reflected how the market was truly beyond the reach of government agencies, authority, and even laws. National geographies and institutional milieus were not implicated in this global market's structure and functioning. Yet through the course of researching the foreign exchange market and its governance arrangements, it became clear that state-enforced explicit and implicit codes that were binding on market participants, or law, were significant factors in the foreign exchange market. Two legal instruments in particular demonstrated the importance of state authority – the Treasury Amendment (TA) and master netting agreements. In mapping their historical trajectories, it became clear that even this most globalized market was legally constructed.

The first legal instrument – the TA – was used by state, market, and quasi-public actors to curtail the ability of a government agency, the Commodity Futures Trading Commission (CFTC), to regulate the New York node of the global foreign exchange market. State law, in this instance, was used as a boundary mechanism preventing market oversight of a specific state actor. The New York node in the global foreign exchange market did not, however, exist in a legal vacuum. It was governed by private and state-based implicit and explicitly binding codes. The TA preserved this patchwork self-regulatory order and allowed it to develop further. Yet, by cordoning off the market from the CFTC, the TA contributed to the "unregulated" appearance of the global foreign exchange market.

The second legal instrument – master netting agreements – was part of an effort to address systemic disturbances created by settlement and counterparty risk in the market. In order for these agreements to be viable, however, they required state-backing. Without this support, these private and explicit codes would not have gained traction in the market or have been binding. Once state enforcement was guaranteed and these contracts began to be used, the master netting agreements restructured market liquidity. Initially this took the generic form of reducing gross settlement and counterparty exposures to net amounts. State, private, and quasi-public actors, however, soon forged a link between these contracts and regulatory capital. Once the connection was established the standardized contracts could be used to minimize the amount of regulatory capital allocated to foreign exchange trading. With the state acting as the ultimate guarantor of rights, the master netting agreements constituted the market by restructuring liquidity.

To document the critical importance of state authority and enforcement in the global foreign exchange market, a variety of primary sources were employed. Archival materials, annual reports, periodicals, and a handful of interviews were used to map the historical trajectories of the TA and the master netting agreements. Documentary evidence contained in the Federal Reserve Bank of New York Archives and the Bank for International Settlements Archives proved to be particularly important in this endeavor. It provided key information about the reasons behind the creation of each legal instrument; the core problems involved in crafting each arrangement; and the factors determining their subsequent use and development. By providing the details about the origins of each legal instrument, such data proved to be particularly valuable in illuminating the foundational role of state authority and enforcement in the market. It revealed how the structure and operation of even this most globalized market was legally constructed.

2. Literature

Initially the rise of global finance was attributed to market actors and various communication and technological innovations, such as derivatives and computational advances. In these analyses cross-border financial integration undermined states' abilities to regulate their economies (Friedman, 1999; Harris, 2004; O'Brien, 1992; Wriston, 1997). In response to such proclamations, some scholars asserted the continued relevance of the state in the face of rapid and volatile capital flows. While recognizing the more delimited authority of states over their political–economic territories, they cautioned against any proclamations about the "death of the state." Instead their research focused on how sovereignty was reconfigured (Cerny, 1991, 1994; Helleiner, 1999; Hirst and Thompson, 1995; Underhill, 1991, 1995; Sassen, 2006). The collapse of the Bretton Woods monetary order, the move to flexible exchange rates, and the liberalization of exchange and capital controls were not the outcome of states being overwhelmed by market forces or telecommunication developments. Through, for instance, international cooperation or crafting new laws, states fostered and encouraged the very markets identified as curtailing their power (Burn, 2006; Helleiner, 1994; Walter, 2005). Even with deregulation and liberalization, states did not necessarily withdraw from markets. A race to the bottom – or "competition in laxity" – was possible, but far from inevitable. Rather liberalization was often followed by a process of reregulation in which states expanded their supervision of markets (Cerny, 1991, 1994) and, in some cases, led to a "race to the top" (Lutz, 1998). The key role of states in markets might have shifted towards one of support, but their agents retained authority over the scope of global financial markets and the conditions under which participants operated (Dombrowski, 1998).