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Europe and the logic of hierarchy

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ABSTRACT

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Building on the view that financial systems from contract and trading structures through regulation are artifacts of law and politics, this paper analyzes the fundamental reasons for the observed hierarchy in all financial systems. Why are financial systems hierarchical? The answer offered here is *mutualization at scale*: balance sheets with access to larger economic catchment areas impart liquidity discipline or elasticity on smaller balance sheets, thereby setting the terms on which the latter operate. Hierarchy then sets the logical limit to the constructive power of law viz. finance. Yet because hierarchy is an abstract, functional requirement, the concrete institutional form that expresses this function is indeterminate *a priori*. This openness is a key predicate of the constructive power of law and politics in finance, allowing us to conceptualize systems that are democratic even while they attend to the specific logic of financial systems. These themes are explored in the context of the European Economic and Monetary Union and its recent crisis. *Journal of Comparative Economics* **41** (2) (2013) 436–446. Social Studies, Harvard University, 59 Shepard Street, Cambridge, MA 02138, USA .

1. Introduction

In outlining a ‘‘Legal Theory of Finance,’’ Katharina Pistor[1] attempts to account for several stylized facts about any financial system: financial contracts are legally constructed, finance is inherently unstable and hierarchical, financial markets are venues for the operation of power embedded in social structure, law is differentially ‘‘elastic,’’ financial systems are essentially state/market hybrids, the future is inherently unknowable, and liquidity is not a free good. Welding these insights together, Pistor produces a stunningly paradoxical axiom of law and finance: finance is not thinkable without the commitment device of formal law, yet strict contract enforcement in the face of uncertainty and crisis-induced scarcity of liquidity would result in system failure. There is a fallacy of composition in law and finance: what is good for the constituent elements is not necessarily good for the system.

This paper attempts to place the same set of facts in a theory that, at its most general level, relates politics to economics, function to form, and logic to contingency. Thus if finance is constructed by law, we must ask what, if any, are the logical bounds of the constructive power of law viz. finance? If fundamental uncertainty generates systemic instability, how does politics amplify or dampen this inherent instability? Why are financial systems essentially hybrid? Why are financial systems hierarchical? What might a democratic financial system have to include?

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[1] ‘‘Towards a Legal Theory of Finance,’’ 2013.

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In order to flesh out these questions, the paper will turn briefly to the European case. Given its inchoate and currently-imperiled state, the European experiment provides an ideal ground to situate these critical questions. It turns out that the last question – *why are financial systems hierarchical?* – provides the key to the others. This question therefore forms the backbone of the paper.

The following is in two main sections. Section 1 deals with the theory of hierarchy in finance as it relates to the problems of instability, hybridity, elasticity, and politics in financial systems. Section 2 runs these elements through the European prism before concluding.

2. The elements of finance

Credit systems – complexes of ''banks'' that are tied together in a hierarchical fashion – have a logic of operation that sets expansion against control: a tendency for destabilizing over-expansion of constituent balance sheets (the Minskian economic *logic*) generates the requirement for social control over such expansion. Deployed at the system's apex, this macroeconomic control is subject to intense political competition. The outcome of this competition – a deeply *contingent* fact – determines the configuration of certain key control mechanisms that have evolved to deal with the system's inherent instability. These control mechanisms – price-based control, non-price-based control, and lender of last resort – have to be fashioned for the particular institutional context if they are to have traction.[2] In other words, the control mechanisms are merely *functions*; the particular *form* they take depends on context.

It is no coincidence that this form/function distinction viz. control mechanisms operates with money itself. Money might be seen as a set of functions: medium of exchange, store of value, unit of account. These functions are borne by different forms of instrument and institution depending again on *context*: time and place; politics, thought, and law. Form is to function as history is to logic, context to system, or politics to economics.

The legal construction of finance is thus very much that of the engineer, just as Pistor suggests. *That* finance has to be rule-bound is a feature of economic logic. *How* these rules come to be constructed is a matter of historical and political contingency. But further, the shape and content of these rules must themselves obey some basic logical elements of finance that set the bounds within which the engineering effort can be exercised. Law might thus be differentially elastic depending on one's distance from the system's core, as Pistor suggests, but even at the core the law is not infinitely elastic. This is not merely because infinite elasticity renders the rule-bound nature of markets a contradiction in terms.

Macroeconomic outcomes can in large measure be understood by the politics of money, that is, the political struggle over the configuration of monetary control mechanisms. A workable theory of finance would give us the range of possible tendencies of any system. These would be logical and transhistorical. But it is politics, thought, and law that determine exactly how these abstract tendencies would play out in concrete, particular circumstance. *Politics picks out the actual from a space of the possible marked out by economics.*

This space of the possible is not defined by economic laws in a deterministic sense. Rather, the institutional logic of credit systems defines an abstract *range of motion*, the degree of institutional flexibility or elasticity that could potentially be exploited in the attempt to build and run the institutions of economic life. It is a space of functional variation wherein the logic of certain economic functions – inherent instability, hierarchy, control, scale – sets the bounds of institutional imagination and legal construction.

This range describes an elasticity of a somewhat different, albeit complimentary kind to that suggestively outlined by Pistor. This range expresses an ''elasticity'' *between abstract function and concrete form*: many distinct legal institutions can be the functional equivalents of each other even though they have different forms. Yet if they are to achieve certain ends, these diverse legal constructions will have to travel along functional rails laid down by the logic of the system. Thus, for example, there is elasticity in determining the type and configuration of the lender of last resort function, but there is no choice to have a lender of last resort function in the first place.

The key thing to note is that in the abstract, these functional bounds are quite wide. Politics and context then enter to delimit the range of possible outcomes. But these bounds never become determinative: there is always room for contingency, luck, chance, play.

2.1. The politics of scale

A key logical attribute of the system for Pistor is the fact of liquidity constraints: by definition, a crisis is a situation in which all positions cannot be refinanced. This implies that the entity that has the ability to generate liquidity at will wields system-altering degrees of power. This entity is the state: for Pistor, this power comes from the state's ability to generate its own currency. Yet this begs the question: why are some state monies better than others? Why is there a hierarchy among state monies themselves? Why do some states have to reach ''outside'' themselves in a crisis, as Pistor notes, whereas others do not? What defines the core and periphery of the global financial system?

[2] See Anush Kapadia, ''Choose Your Weapons: Control Mechanisms for a Market-based Credit System,'' in Chris Desan ed., *Inside Money* (University of Pennsylvania Press, forthcoming).