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THE NATIONAL BASES OF REGIME FORMATION:  
THE CHALLENGE OF SUPERVISING INTERNATIONAL CAPITAL MARKETS

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This paper was first drafted while I held an International Affairs Fellowship from the Council on Foreign Relations. It was revised in February 1990 for presentation to the Workshop of the Political Economy Research Group, University of Western Ontario.
The National Bases of Regime Formation:
The Challenge of Supervising International Capital Markets

Overview

Modern financial markets rest on political foundations. The institutions and policies of governments create those foundations. As contemporary national economies have become increasingly integrated, structural linkages between national financial markets have deepened. Underlying political structures and public policies in the financial sector of the global economy have accordingly become intrinsically interdependent. With a focus on the supervision of financial intermediaries, especially commercial banks and securities companies operating in the markets of advanced industrialized countries, this note explores some of the consequences of that interdependence. After setting out a perspective on the relationship between financial systems and macroeconomic performance, it outlines key governmental attempts to control that relationship. In recent years, many of those attempts have had an intergovernmental character and coordination problems have arisen. The paper illustrates the types of structural hurdles policy coordination efforts must overcome by sketching the historical development of unique supervisory structures in the United States, Japan, Canada, and Germany. Given the persistence of those structural differences, and the attendant complications posed for resolving international coordination problems, the paper supports arguments for strengthening the role of multilateral political institutions in this sector.
I. Background

1. Financial intermediation

Because they have been changing, expanding, and linking together so rapidly during recent years, the structures of national financial systems have been at the center of a growing body of research. This section provides an overview of theoretical and empirical studies of relevance to the issue of international financial supervision.

In advanced market economy countries, financial systems provide a necessary mechanism for reallocating scarce capital from sources in surplus to users in deficit. This intermediation facilitates economic growth by making it possible for those users to transform and create real assets such as tangible goods and intangible services. 1/ Put simply, a commercial bank performs a direct intermediation function by purchasing financial resources from savers and then selling them to investors, thereby giving rise to financial liabilities (deposits) and assets (loans) which it carries on its own books. To sustain those liabilities and assets, a bank needs to maintain confidence in its ability to maintain itself as a going concern (solvency) and in its ability to meet payment demands on a timely basis (liquidity). An adequate level of capital (shareholders' funds and reserves) and prudent management of its liabilities and assets, are essential elements in this regard.

Various types of securities companies and investment banks, as well as the investment or merchant banking arms of commercial banks, often perform an indirect intermediation function by facilitating the transfer of financial resources from savers to investors without necessarily purchasing or selling liabilities on assets for ultimate disposition in their own accounts. Bond, stock, and commercial paper issues provide examples. An indirect intermediary enables a transfer of funds to occur efficiently in such transactions by providing supportive commitments

1/ See Bryant, 1987, ch. 2.
which vary in levels of risk, backing, or managerial acumen. A firm underwriting by an intermediary, for example, typically entails the purchase and temporary holding of an issue in the expectation of onward sale to ultimate investors. A "best efforts" financing assurance entails only an expression of confidence on the part of an intermediary concerning its ability to gather required financial resources for an issuer. A guarantee involves a commitment by an intermediary to provide financing directly only in the event that a client fails to meet some obligation. By providing these and more complicated services, indirect intermediaries mobilize resources for productive investment. In recent years, a great deal of innovation has in fact occurred in the techniques of "financial engineering." Through combinations of such devices as swaps, (which enable debtors with differing expectations to exchange payment streams over time), options, (which confer a contractual right to buy or sell a specific financial investment), and securitization (which usually entails transforming bank loans into marketable securities) intermediaries have become increasingly sophisticated in helping clients (including other intermediaries) manage the various risks involved in financial transfers. Distinctions between "direct" and "indirect" intermediation have accordingly become less clear. 1/

In general, the larger the amount, the greater the complexity, and the firmer the commitment involved, the stronger must be the financial condition of the intermediary itself. Again, strength here implies a combination of capital, track record, and managerial acumen adequate to provide confidence to clients, shareholders, and other parties with an interest in the continued existence of the intermediary. Note that even the ability of an intermediary to provide supportive commitments that are technically considered as "off-balance sheet," that is, entailing no direct use of its own borrowed or invested funds, depends fundamentally on the perceived strength of its underlying balance sheet and of its management.

1/ For background, see Bank for International Settlements, 1986.
1. Financial structures and economic growth

For financial intermediaries to perform their functions efficiently, competition between them must take place according to understood ground rules. In addition, reliable and acknowledged procedures for dispute settlement are necessary to allow that competition to endure over time, while an arbiter is needed to maintain an overarching balance between the interests of savers, investors, intermediaries, and other parties affected by the intermediation process. This is necessarily a political role. Ever since the rise of the modern international system, wherein ultimate political authority rests with states, the governments of states have played that role. In short, governments, responding to various pressures and interests, including in recent times an apparent general public interest in stable economic growth, shape the market structures within which competition between intermediaries takes place.

To be sure, rudimentary financial markets predate the development of modern states. Historical evidence abounds on the early existence of trade in monetary assets and of basic lending and saving functions in all but the most primitive societies. ¹/ Until the late 17th century in Europe, however, such activity was generally carried out by relatively few unspecialized economic actors using rudimentary financial instruments. As a leading historian of financial systems, Raymond Goldsmith, points out, marked changes occurred with the dawn of early modern economies after 1700. Specialized financial institutions began to proliferate both in number and type. Moneychangers, pawnbrokers, merchant lenders, and early banking houses, were gradually replaced by the precursors of institutions identifiable today as commercial banks, investment banks, insurance companies, mortgage companies, and pension funds. Primitive financial instruments were supplanted by paper money, checks, and various types of securities. ²/ It is surely not coincidental that all of this financial development and diversification

¹/ See Goldsmith, 1987; Braudel, 1984.
occurred simultaneously with the rise of the state system following the Peace of Westphalia in 1648. In retrospect, one astute analyst of the international system, Robert Gilpin, refers to the confluence of political and economic development indisputably evident in Europe by the 18th century as a "financial revolution," characterized fundamentally by the rise of "political" money. 1/ Henceforth, financial development and political development, and one might add financial competition and political competition, would be inextricably bound together, even if precise causal arrows would remain difficult to draw.

The desire to shed light on the precise relationship between the development of the structures and instruments of financial intermediation and the process of economic growth has stimulated an expanding scholarly literature. To use Edward Shaw's phrase, "financial deepening" the accumulation of financial assets at a faster pace than real assets, has for economists commonly come to be associated with the movement of national economies along the trajectory of industrialization. 2/ Economic growth ultimately depends upon the transformation of real assets (e.g., natural resources into commodities and tradeable goods) and financial intermediation is often viewed as playing a facilitating and, at times, catalytic role in that transformation. As Ralph Bryant summarizes current research on the subject, as economic development proceeds, the financial superstructure of an economy tends to expand relative to the real infrastructure. Financial institutions tend over time to become relatively more important, and both financial institutions and financial instruments tend to become more specialized and more diverse. 3/ There is also some evidence that up to a point a financial system may itself develop more rapidly than the real economy underneath it, and that financial deepening may even proceed even as the

real economy declines or stagnates. 1/ Although work on the catalytic effects of financial deepening as yet only points to the potential usefulness of financial innovation and not its essential causal role in the overall process of economic growth, the contemporary actions of governments would appear to indicate a considerable degree of political sensitivity in this regard. 2/ Perceptions of the potential positive role of finance contribute to this sensitivity. The negative consequences of periodic financial crises also obviously contribute to it.

1. Financial crises

Financial crises, often defined in terms of sharp, changes in financial prices or rapid shifts in the liquidity preferences of asset holders, have been endemic to the history of capitalist development. 3/ The questions of why this should be so and what can be done about it have spawned much debate in economic circles. According to one school of thought, which is conventionally termed "monetarist," financial crises will not naturally arise under conditions of stable rules for money supply growth, efficient markets, rational expectations, and flexible exchange rates. In such a world, financial crises necessarily imply errant governmental policies which disturb one or other of those conditions. 4/

Another major theoretical tradition begins with the premise that capitalist financial markets are not naturally robust but, on the

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2/ Research on the catalytic influence of innovative institutional developments such as the rise of investment banks in the case of the development of the German economy and the entry of foreign institutions into closed economies, is relevant here. See generally Bryant, 1987; Gerschenkron, 1968; Zysman, 1984; Pauly, 1988.
3/ Kindleberger and Laffargue, 1982, 1-2. Note that I am concerned here with financial crises of a systemic character, not with the more routine (and usually isolable) difficulties associated with the failure of particular institutions. For an analysis of the latter type in the banking sector, see Sinkey, 1985.
contrary, are intrinsically fragile. In the course of recurrent business cycles, this fragility is seen to be especially evident during the late stages of economic booms. Expecting a continuation of favorable economic conditions, firms take on too much debt, banks lend too aggressively, firms become over-extended, and, in the extreme, speculative "bubbles" develop in financial asset prices. In such circumstances, even mild exogenous disturbances, changes in interest rates, or miscalculations by market participants may cause sharp shifts in expectations and massive movements to liquidate financial assets before their value declines. Liquidity crises, banking runs, and macro-economic contractions are theorized to result from such naturally recurring developments. Since the 1930s, so theorists of the "fragility" school contend, the worst outcomes have been avoided not by any self-correcting market mechanism, but by the concerted intervention of central banks serving as lenders of last resort and by the more generalized ameliorating effects of large government budget deficits. At the price of chronic inflation, deep depressions are thus avoided but underlying financial systems remain unstable and crisis-prone.

At the center of financial crises, whether they manifest themselves in bank runs, sharp drops in financial asset prices, or large operating deficits for financial institutions, is a dramatic loss of confidence on the part of wealth holders. In the extreme, their preferences shift massively toward holding wealth in the form of currency or tangible assets and away from financial assets. This loss of confidence is usually related, in turn, to changes in general expectations concerning the future course of the real economy.

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1/ The tradition goes back to Fisher, 1933.
3/ Shafer, 1987, p. 58. Drawing on a set of propositions associated with Frank Knight and John Maynard Keynes, Shafer notes, "Uncertainty reflects the ever-changing nature of the economic environment in technical terms, the random element in economic affairs does not seem to be adequately represented by stationary probability distributions, as assumed in rational expectations models."
The risks associated with uncertainty about the future lie at the core of financial intermediation processes. The types of risk that need to be managed vary with the sources of uncertainty and, at least theoretically, all are reflected in the price of any particular financial asset. Risks may be specific to individual financial transactions or they may affect an entire market. 1/ Financial crises bring the latter type of risks, systemic risks, to the fore.

For financial institutions, the elimination of all types of risk, or all sources of uncertainty, is not only impossible but undesirable. Intermediaries are paid to assume and manage risks; uncertainties may indeed be seen as their ultimate sources of profit. Generally speaking, the freer the market, the more obvious is the connection between uncertainty and profit. "Only by ceaselessly looking for new opportunities where information is unevenly distributed and uncertainty is great," writes Jeffrey Shafer on this subject, "can a flow of profits above a safe return or capital be sustained in the face of unrestrained competition". 2/ But these sources of profit may be seen as the "normal" risks of a business on an industry. Systemic risks on the other hand, risks related to the possibility that the very foundations of financial markets may be shaken or destroyed by unforeseen events, cannot effectively be controlled by individual intermediaries. The management of systemic risks necessarily devolves on governments.

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1/ Examples of specific risks are credit risk (the risk that a counterparty to a transaction may default), interest rate risk (the risk that interest rates will fluctuate adversely during the life of an asset), exchange rate risk, and country risk (in a cross-border transaction, the risk that foreign exchange needed to settle obligations will be unavailable or blocked).

2/ Shafer, 1987, p. 60. As Shafer points out, this type of innovation is the financial analogue of the processes of "creative destruction" Joseph Schumpeter (1943) saw as the motor force of all capitalist markets.
II. Supervisory Policy

1. Regulation and supervision

Since stable economic growth and the threat of financial crisis have important political consequences, respectively positive and negative, governments are concerned about the depth and stability of financial markets. Without exception across advanced industrialized states, governments have adopted a range of policies to regulate and supervise those markets and the institutions that operate within them. Although the extent and character of those policies have typically varied by country, a reflection of divergent histories, traditions, and governing structures, common motives for their universal existence may be identified.

The terms "regulation" and "supervision" are often used interchangeably in the financial sector. "Regulation" is, however, the more general term and refers mainly to governmental attempts to influence market structures or outcomes in order to promote various public interests related, for example, to questions of economic concentration, stability, adequate competition, industrial or regional development, financial equity, and national sovereignty. "Supervision" is more specific and usually refers to official oversight of a financial system and of its institutional participants to enforce explicit or implicit prudential regulations. Since contemporary governments have assumed responsibility for the overall safety and soundness of financial markets under their purview, the supervision of market participants may initially be seen as the necessary consequence of official liquidity support provided during periods of emergency, usually by central banks acting as lenders of last resort. It may also be viewed as the mechanism through which governments honor commitments to protect depositors or investors in financial markets and to ameliorate threats to the macroeconomy potentially arising from those markets.

Analysts have proposed various taxonomic devices to differentiate between the complicated policies encountered in this sector. Richard
Dale, for example, usefully distinguishes between "preventive" and "protective" policies, the latter designed to limit the risks of systemic breakdown, the former to monitor individual financial institutions in an effort to avoid future problems. 1/ Using such a dichotomy, limits on price competition, standards for capital and liquidity, and constraints on various types of business activities would fall in the "preventive" category. Such regulations are typically enforced through licensing laws, financial reporting requirements, official on-site or computer-based examinations, cease-and-desist orders, reliance on industry-based self-regulatory organizations, and other supervisory techniques. It is useful to note that policy reforms implemented by many countries during the past few years under the label "deregulation" have mainly been in this area. Preventive regulations have been lifted, the scope for competition widened, and, therefore, risk of failure for any specific institution increased. "Protective" policies, on the other hand, would include establishment of deposit insurance schemes, general official oversight, creation of lender of last resort facilities, and governmental takeovers of troubled institutions.

Other observers classify the same policies according to the economic incidence level of their intended effects. Policies of prudential oversight aiming at the stability of a financial system as a whole, or of the central payments system of an economy, may be seen as "macro-prudential." Conversely, "microprudential" policies, although capable of having more generalized effects, are designed more specifically to protect individual depositors or investors. 2/ Other regulatory initiatives designed to achieve a range of political objectives have an impact on financial markets, but these are precisely the two types of policies with which we are concerned here. The following table arrays such policies along two dimensions: the level of their economic incidence and the level of government at which policymaking occurs.

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2/ For example, see Bryant, 1987, page 119.
## The Policy Context for Financial Supervision

<table>
<thead>
<tr>
<th>Macro</th>
<th>Micro</th>
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<tr>
<td><strong>Payments systems oversight</strong></td>
<td>Intermediary Licensing</td>
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<tr>
<td><strong>Fiscal/monetary/ balance of payments policy spillovers</strong></td>
<td>Lender-of-last-resort-facilities</td>
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<tr>
<td><strong>National</strong></td>
<td>Disclosure rules</td>
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<tr>
<td><strong>Capital controls/ liberalization</strong></td>
<td>Balance sheet strictures</td>
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<td><strong>OECD instruments</strong></td>
<td>Consumer protection rules</td>
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<td><strong>Level of Policymaking</strong></td>
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<td>EC internal market plans</td>
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<td>GATT negotiations on services</td>
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<td></td>
<td>BIS/G-10 consultations on institutional supervision, capital adequacy, liquidity, etc.</td>
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<td>IOSCO work programs</td>
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<td>OECD work programs</td>
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Most of the supervisory policies evident in contemporary financial markets have been developed at the national level in response to actual or anticipated problems (upper right quadrant above). In every advanced industrial country, for example, various laws and official practices have a direct impact on financial markets. The majority of these strictures attempt to assure the stability of those markets by preventing intermediaries from undertaking actions deemed harmful to the interests of consumers of financial services. Others provide emergency support from intermediaries facing unusual and potentially dangerous stresses. As national markets have become more interconnected in recent years, many of these "micro" level policies have required coordination across political boundaries. Prominent examples of such policy coordination efforts are listed in the lower right quadrant.

At the "macro" levels a number of policies directly affect financial markets (upper left quadrant). As at the "micro" level, the need for a greater degree of cross-national coordination has been evident for a number of years. 1/ Unlike the notable progress achieved on "micro" issues, however, on the key "macro" concerns which lie behind the fundamental interests of states in financial markets, the connection between financial deepening and macroeconomic stability and growth, there is an absence of a reliable and adequate mechanism for promoting policy coordination (in the sense of representing in an authoritative dorum at least all of the important interdependent national player). This vacuum would appear to persist despite the plausible diagnosis that such a coordinating mechanism is rapidly becoming all the more necessary by virtue of the political decisions of national authorities to allow their markets ever more deeply to integrate. The BIS is very specialized and limited in the size and character of its membership. The G-5/G-7 consultation mechanism is episodic and incipient at best, as well as severely limited in its membership. The OECD is more consultative than authoritative and its existing instruments have limited scope.

1/ See Pauly, 1989.
2. **Financial supervision at the national level**

With both "macro" and "micro" supervisory policies in mind, relevant literature often focuses on functional differences between various types of financial intermediaries. In most countries, distinctions have traditionally been drawn in statute or official practice between the supervision, for example, of commercial banks, securities companies (investment banks), insurance companies, fiduciary institutions (trust companies), and other specialized institutions (credit unions, mortgage companies, mutual funds). Supervisory authorities in the banking sector have typically focused on issues like ensuring the safety of payments systems, securities regulators have concentrated on enforcing rules against insider trading and other types of fraud, and so on. To a considerable extent in recent years, such distinctions have in fact become blurred as financial innovation, regulatory reform, and technological development have encouraged intermediaries to diversify the traditional bases of their operations. 1/ Nevertheless, even in cases where specific institutions have long been permitted to diversify their activities, functional separation to some extent has existed in the statutory base and everyday practice of official financial oversight. Although specifically discussing the banking sector, a point made by Rinaldo Pecchioli remains valid and could easily be extended to the securities sector.

"The supervisory systems of member countries [of the OECD] are patterned on institutional frameworks which differ considerably from country to country, reflecting distinctive political, legal and administrative traditions, heterogeneous financial structures as well as different practical and philosophical approaches to prudential supervision. To a large extent, the existing institutional differences derive from the specific motivations which led to the introduction of supervisory schemes and their subsequent evolution in the earlier years of this century." 2/

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1/ See Watson, et al., 1988, pp. 35-44.
Given the evident interest of states in their financial markets, it is no coincidence that financial structures vary with the deeper structures of states. It is, of course, arguable that those markets are becoming increasingly interdependent, but states remain responsible for the political architecture that undergirds them at the national level. Within the advanced industrialized world, and focusing mainly on banking and securities markets, that architecture may be seen to take the four broadly differentiated forms specified in the following figure.

A Typology of State/Market Structures in the Financial Sector

- Centralized
  - <<< Japan
  - Germany
- Universal
  - <<< Canada
- Segmented
  - <<< United States
- Decentralized
In general, the financial markets in which banks and securities companies operate may be arranged along a theoretical spectrum ranging from a purely "universal" market—where institutions are relatively unrestricted in the variety of financial activities open to them—to a purely "segmented" market—where institutions are functionally limited. Although they are currently changing, the markets of the United States, Japan, West Germany, and Canada still provide useful archetype of variations within such a spectrum. With their traditional ability to underwrite corporate securities, hold such securities in their own portfolios, and engage in standard commercial banking, West Germany's banks would fall very near the universal end of the spectrum. At the other end of the spectrum would fall American banks, whose highly restricted and now gradually changing functional powers date back to the Great Depression. In the wake of rapid deregulatory moves by provincial and federal regulators during the 1980s, Canada is moving quickly from the segmented pole toward the universal pole. During the same period, Japan, like the United States, only reluctantly began breaking down the fundamental functional barriers long constraining its financial institutions.

Similarly, policymaking structures underpinning financial markets may be differentiated by the degree of centralization and cohesion at various levels of government. In view of its concentration of financial regulatory authority in the Ministry of Finance and in view of the traditionally close ties of the Bank of Japan to the Ministry, Japan's structures may be viewed as highly centralized. Conversely, with its traditional division of regulatory and supervisory authority between federal and state governments, as well as among discrete agencies within those governments, the United States' system is highly decentralized. Germany's arrangements may be viewed as closer to Japan's, at least with respect to those institutions most active internationally, while Canada's has historically been closer to its American neighbor. A sketch of the historical development of the regulatory and supervisory structures evident in each of these four cases follows.
I. National Structures

1. United States

Both observers and participants frequently describe the American system of financial regulation and supervision as exceedingly complicated, having developed over the years by accretion and in response to various financial crises in the nation's history. 1/ The American constitution left ambiguous the precise separation of financial regulatory powers between federal and state governments. Although federal authorities had the right to issue currency, both levels of government over time claimed the prerogative of chartering banks. A two-tiered or "dual" banking system resulted.

By the beginning of the twentieth century the shared regulatory responsibility of federal and state governments became more contentious as technological and economic developments stimulated bank moves toward the establishment of branch networks. Against a background of pressures to extend such networks across state lines, a battle erupted between federal and state regulators, as well as between national and state banks, culminating in the McFadden Act of 1927 and the Banking Act of 1933. These laws allowed national banks to set up branches first in their home cities and then in their home states provided state chartered banks in the same territory were allowed similar privileges under state law. Although originally seen as a liberalizing development, the laws effectively banned interstate branching by either national or state banks, a ban later reinforced by the Bank Holding Company Act of 1956 and its 1970 amendment (the "Douglas" Amendment). These statutes extended federal supervisory authority over bank holding companies (corporate structures developed in the late 19th century and in the 1920s to hold shares in one or more separate banks—a device potentially

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1/ For background, see Heggestad and Shepherd, in Adams, 1982; Benston, 1983; and Haraf and Kushmeider, 1988.
useful for skirting geographic barriers to entry) and forbade them to acquire banks outside of their home states unless specifically authorized by host state law. In recent years, traditional geographic barriers have been collapsing under the weight of regional banking pacts established by state governments to allow the reciprocal entry of out-of-state banks. By the early 1990s, only the vestiges of the traditional system are expected to remain.

Functional segmentation in the American financial system developed in a parallel fashion. Public concern about potential conflicts of interest arising from too-close ties between commercial banking, investment banking, and other financial services became especially prominent in the United States during the Great Depression, but the roots of the issue go back to public inquiries at the turn of the century. In the wake of a national clamor over speculative financial activities commonly viewed as responsible for the collapse of 1929, Congress finally reacted to this concern by passing legislation strictly separating the short-term, commercial activity of deposit-taking institutions from the underwriting and distribution of securities. The Banking Act of 1933, including the famous Glass-Steagall provisions, sharply diverged from the continental European model of "universal" banking as it sought to segment markets along functional lines to facilitate the political control deemed necessary for economic stability and to preclude perceived unacceptable concentrations of economic power. In addition, the Securities Act of 1933 and the Securities Exchange Act of 1934 created a new federal agency, the Securities and Exchange Commission, to oversee the newly segmented Investment business. Congress also later heightened the wall separating commercial banking from other sectors of the economy in the 1956 Bank Holding Company Act which forbade such companies from owning more than 5 percent of the shares of nonbanking companies. With recent developments in the
securities sector and in the troubled savings and loan industry, these functional barriers have also been under pressure. 1/

Traditional distrust of concentrations of economic power also affected the ability of the federal government to create an American central bank. In fact, except for early unsuccessful attempts, no proximate institution existed until 1913, when the Federal Reserve System was created, initially to act as lender-of-last-resort to basically solvent but temporarily illiquid banks. Following World War I the Federal Reserve assumed broader domestic and international responsibilities; in the aftermath of the 1929 debacle its mandate to control the nation's money supply and monetary conditions was strengthened. 2/ Since its inception, the Fed has carried out its duties principally through the commercial banks belonging to the Reserve System. To provide for the stability of the System, the Fed also was given a degree of supervisory authority over member banks and eventually over all bank holding companies.

Related to historical anxieties about concentration and control in American banking has been the question of safety. Following a wave of bank failures in the Depression years, Congress passed the Federal Deposit Insurance Act in 1933; various states also created their own insurance schemes during the same period. The Act required coverage for all national banks and, in tandem, the Federal Reserve made it essential for all state member banks. The Bank Holding Company Act of 1956 further extended the scope of the Federal Deposit Insurance Corporation by the 1933 Act.

1/ The definition of the business of banking has often been problematic. Most of the relevant legislation assumes that its essence is the acceptance of deposits subject to withdrawal by drafts drawn by the depositor. Such a conception has typically left open to "nonbanks" many financial functions, such as granting loans, provided conventional deposits are not taken.

2/ Unlike its counterparts in other developed countries, the Federal Reserve is itself a decentralized institution consisting of 12 separately incorporated Reserve Banks and a Board of Governors in Washington.
Controversy over the structure and functions of regulators themselves is another persistent and relevant theme in the history of American financial regulation. The Federal Reserve supervises and examines all state chartered banks which are members of the Federal Reserve System and all bank holding companies. The Comptroller of the currency, a semi-independent arm of the Treasury Department, supervises and examines all national banks; but since most national banks are owned by holding companies, the Federal Reserve also oversees them. The FDIC supervises all insured state and national banks. The Department of Justice has authority to review bank mergers and acquisitions to ensure that antitrust statutes are not violated. In addition, state banking departments examine and supervise all state licensed banks regardless of their status in the Federal Reserve System or with the FDIC; the states also oversee mergers involving state licensed banks. The Securities and Exchange Commission has oversight responsibilities for the nation: securities market, and delegates' much detailed regulation to the various national and regional stock exchanges. As the securities' powers of banks expand, SEC rules increasingly affect them. This jurisdictional overlap is compounded when it comes to international banking matters. The Federal Reserve is responsible for international prudential issues; a Fed officer, for example, sits on the Committee of the Bank for International Settlements working on multilateral supervisory issues. To the extent that such issues impinge upon the operations of national banks, the Comptroller of the Currency is also involved. On the related matter of seeking fair treatment for U.S. financial firms' operations overseas, the Treasury Department takes the lead, but insofar as more general foreign policy or international legal questions arise in this connection, the State Department often plays a role. Similarly, when supervisory problems involve the possible extraterritorial application of U.S. banking laws, State, Treasury, and the Justice Departments may all be concerned.

This proliferation of supervisory agencies has a number of implications. The most obvious is the potential for a lack of coherence and coordination which arises from the differing priorities and goals of the
regulators on such issues as safety, competitive efficiency, monetary control, and international cooperation; indeed, some of these priorities and goals may not be wholly compatible at times. For example, the FDIC tends to be more conservative on questions of safety; the SEC and the Comptroller often gives priority to matters of market efficiency; the Fed frequently emphasizes monetary control issues. In addition, since individual banks may retain some options regarding principal oversight regimes, the possibility for "competition in laxity" between supervisory agencies has long existed. In light of the problems posed by supervisory overlap, the federal government has periodically created task forces to make recommendations for streamlining and reform. Since these efforts began in 1919, however, a political consensus strong enough to push through a wholesale reorientation of regulatory policy in this sector has never existed.

In the 1970s and early 1980s obvious changes resulted from increasing pressures on interest-rate controls and on geographic and functional barriers to entry. High and variable inflation rates undercut interest rate ceilings imposed by governmental authorities. Nascent interstate banking networks had already been set up by the mid-1970s, despite the absence of clear enabling legislation. Technological innovation and the phasing out of interest rate ceilings in the Depository Institutions Deregulation and Monetary Control Act of 1980 made policies aimed at market segmentation increasingly difficult to sustain. That same Act required all deposit-taking institutions (whether holding federal or state charters) to maintain federal reserve requirements.

Several other pieces of federal legislation reshaped the regulatory landscape in recent years. Among them the International Banking Act of 1978 was notable for ratifying the openness of banking markets under federal jurisdiction by extending "national treatment" to foreign-owned banks operating in the United States. Also significant was the International Lending Supervisory Act of 1983, passed in connection with a quota increase for the International Monetary Fund. The Act essentially
extended a range of explicit federal controls on the international lending of American commercial banks by stipulating stricter standards for capital adequacy, loan disclosure, various operating procedures. 1/

One effect of these new standards was to heighten tensions between regulators whose mandate focused more exclusively on domestic market safety and bankers who now found it more difficult to compete internationally. Partly in seeking to resolve this tension, American bank supervisors were prominent in subsequent multilateral efforts among the G-10 nations to reach agreement on international standards for capital adequacy in the banking sector. 2/

Ironically, when the 1983 Act was passed, financial regulatory policy at both federal and state levels was moving along a general trajectory which seemed designed to enhance the competitiveness of individual institutions and the efficiency of markets. That trajectory was often labeled "deregulatory," somewhat disingenuously since commercial banking in particular remained a fully regulated industry. The erosion of interstate banking barriers and the demise of direct price controls were consistent with this trajectory. Also consistent was a gradual erosion of functional constraints on banks, especially obvious in the case of the Glass-Steagall restrictions.

2. Japan

Financial liberalization in Japan, a process of structural change which emerged at the end of the high growth era of the 1960s, accelerated dramatically in the aftermath of the turbulent 1970s. At base, this process involves adjusting the post-World War II financial system to the changed needs of a maturing domestic economy reshaped by slower growth and persistent trade surpluses. In the consequent agenda for domestic policymakers, the adaptation of regulatory practice to monetary pressures ranks high.

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1/ Friesen, 1936, Chapter 2.
2/ See Mark Allen, et al., April 1989, Chapter IV.
Scholars argue about the precise significance of Japan's financial structure in the pattern of economic growth which dramatically pulled Japan out of the devastation of World War II. Few doubt, however, that the idiosyncratic interaction of bank lending strategies and government guidance exerted a critical influence on the shape of a dual domestic economy characterized by an employment-generating, domestically-oriented small business sector and a reserve-generating, export-oriented industrial sector. Reconstruction and development involved encouragement of a high popular savings rate, repressión of interest rates, effective financial intermediation through institutions strictly segmented along functional lines, and a heavy reliance on monetary policy for stabilization. Undoubtedly a cohesive and centralized government played an important guiding role, especially in the immediate post-war years, but the structure of the financial system with which it worked had come out of the war and occupation years relatively unchanged; the Government was itself therefore partly constrained by a structure which reflected an earlier period of Japan's economic history.

Research on the era of the Meiji Restoration has brought to light the fundamental importance of competitive forces within the private sector. It has also emphasized the significance of incentives provided by essentially capitalist markets for close concertation between financiers and industrialists, even in the absence of direct government guidance. 1/ Although government maintained a privileged position in the new system, its principal influence came through the indirect effects of an expansive fiscal policy and through the support function of the central bank. 2/ As Japan emerged from the wreckage of war, its

1/ See Patrick, in Cameron et al., 1967. Significantly, the German model, with its considerable flexibility for leading banks, was the one which attracted Meiji planners as they set about creating a regulatory framework for the banking sector.

2/ The government also participated directly in those private markets through several publicly-owned institutions, the most noteworthy of which were the Bank of Yokohama (now the Bank of Tokyo) and the Industrial Bank of Japan. Although both are now private institutions, their continuing influence in the market and in government is substantial, if subtle.
banks reasserted themselves as the pivotal providers of funds for investment. Private sector decisions and the acquiescence of occupation authorities reconstituted a financial system based upon traditional indirect financing methods. A recovering government, content with a guidance mechanism which rested on a closely supervised inter-bank market, did its part to discourage the development of direct financing alternatives, such as equity and bond markets. Over time, indirect channels declined somewhat in importance but persisted in dominating financial flows in the economy. Especially in comparison with the United States, for example, Japan's securities market remain underdeveloped.

Reflecting the dual structure of the economy as a whole, the banking system was, after the war, concentrated at the wholesale, corporate, and national level and decentralized at the deposit-gathering local level. At both levels, nonprice competition remained intense. Profits were of course important, but market share often constituted the critical indicator of success. Government, in turn, worked with the system to attain broad national goals, and sometimes attempted to accelerate market-defined outcomes. On a continuous basis, however, government also played a regulatory role familiar in other industrialized countries as it sought to establish rules to mitigate competitive "excesses." In this role, the strength of centralized state institutions appears evident, especially when Japan is compared to a country like the United States. In return for government's legitimation of property rights within the system and its confidence-generating prudential oversight, private market participants accepted extensive monetary controls and U.S.-style functional segmentation.

The system in place at the end of the American occupation distinguished between "ordinary" banks (including the major "city" banks as well as smaller regional banks); specialized banks for international business, trust business, and the provision of long-term credit; and a myriad of local institutions catering to small business, agriculture,
forestry, and fisheries. 1/ In addition, the Securities and Exchange Law of 1948 created a niche for securities companies by forbidding banks to underwrite corporate securities. Insurance companies, which along with trust companies were permitted to manage pension funds, and housing finance companies rounded out the segmented structure of private domestic finance. Supplementing that structure were a range of institutions owned or supported by government, most notably the postal savings system.

The governmental apparatus regulating these institutions, and implementing monetary policy through them, centered around the Ministry of Finance (MoF), which was principally responsible for policy formulation, and the Bank of Japan, which handles day-to-day operations in the money markets. 2/ Actual policy, however, reflected a subtle interaction between the Ministry, the Bank, and the major players in those markets. Although MoF clearly predominated at least until the end of the high growth period, the balance of influence has changed over time. Combining the regulatory, supervisory, and planning functions often split in other OECD governments (as well as budgetary, tax, and customs functions), the Ministry remains key. Nevertheless, under the pressure of burgeoning governmental debt, expanding corporate liquidity, increasingly competitive market conditions, and the internationalization of core industries and banks, its power has somewhat diminished. Symptomatic of this shift, informal rules and subtle guidance mechanisms have gradually been supplemented or replaced by more formalized structures outlined, for example, in the 1981 Banking Law which replaced a statute starting from 1925.

1/ Several of the city banks, for example, Mitsui and Mitsubishi, were key parts of so-called "keiretsu" industrial groupings. The keiretsu, in the main, were often reconstituted loosely on the basis of the powerful pre-war "zaibatsu," the family dominated conglomerates central to the industrial development of the Meiji period.

2/ The Bank is legally distinct from the government and is expected to provide independent advice. In reality, the connection has been quite close. Top personnel, for example, often come from the Finance Ministry. As Japan moves toward open-market operations as the principal tool of monetary policy, however, tension between the Bank and the Ministry, a sign of growing independence, is increasing.
The administration of the banking system, control over entry, ongoing supervision, and oversight of expansion abroad come almost entirely under MoF's discretion. Among the three bureaus of MoF most directly engaged in financial regulation—the Banking, Securities, and International Finance Bureaus—the Banking Bureau clearly enjoys primacy.

Within the Banking Bureau one division, the Commercial Banks Division, is responsible for supervising the activities of all major banks, including 12 city banks, the Bank of Tokyo, 64 regional banks, 3 long-term credit banks, 7 trust banks, and 76 foreign banks. Approximately 1,000 smaller banks and credit cooperatives are supervised by their own division, as are insurance companies and government-affiliated institutions. Some 250 domestic and foreign securities companies report to the separately organized Securities Bureau. Insofar as the operations of domestic institutions abroad or of foreign institutions in Japan raise policy issues relating to foreign exchange, foreign capital flows, international organizations, and the like, the International Finance Bureau plays a role. Without direct "line" responsibility, however, the influence of the Bureau remains of a second order. Policies emanating from MoF may be administered directly or through the operations of the Bank of Japan.

The relationship between MoF and the banks has changed in recent years as the internal structures and operating strategies of the latter have adapted to the economic maturity of their domestic markets. Especially after the second oil shock in the late 1970s, various internal and external pressures were drastically reshaping those markets and that relationship. Prominent among these pressures were increasing interest rate sensitivity in all economic sectors, partly induced by inflation, and increasing liquidity, an immediate result of slower domestic growth. These affected both sides of bank balance sheets. On the asset side, corporate loan demand decreased and the availability of internally generated funds weakened traditional lending relationships, developments exacerbated by rising recourse to direct financing.
techniques. 1/ On the liability side, corporate savers found more sophisticated, higher yielding investments elsewhere and individual savers developed a marked preference for the effectively better terms offered by the Post Office and by inventive securities companies. Compounding the difficulties thus caused was the growing size of the national debt and the method of financing it by forcing banks to buy and hold low-yielding government securities. Aside from their impact on bank profitability, these pressures worked to undercut the system of interest rate controls which characterized Japan's post-war money markets. For related reasons, also under stress was the functional segmentation which formerly made clear distinctions between the various types of financial intermediaries. With a gradual shift to direct financing, the aggregate income of securities companies increased by a factor of ten during the period 1960 to 1985, despite the fact that the actual number of such companies in operation declined by more than half. 2/ The changing needs of their customers heightened competition both between banks and securities companies and among the banks themselves. The administrative lines between them gradually began to blur, partly as a result of exceptions made for foreign institutions on grounds of reciprocity. In turn, traditional techniques of monetary policy implementation, such as Japan's version of moral suasion, became less effective. Official perceptions of the value of freer domestic markets slowly changed and the ability of government to avoid moves toward more efficient markets and more formalized supervisory techniques was reduced. 3/

These internal pressures for change have been heightened by the interaction between domestic and international markets. The importance of this interaction for domestic policymaking has a number of aspects. The most fundamental relate to Japan's transformation from international debtor to the world's largest creditor. Such dramatic change obviously

1/ See Royama, Winter 1983-84.
2/ Nomura Research Institute, 1985, pp. 293-296.
had an institutional impact. In 1965 Japanese banks maintained 56 overseas branches, most operated by the Bank of Tokyo. By the later-1980s, city banks, long term credit banks, trust banks and regional banks operated far-flung global networks. This expansion had consequences at home as lenders and borrowers move effectively engaged in arbitrage between internal and external money markets. 1/ Although this complicated the task of domestic monetary control under the post-war system, and helped encourage banks and securities companies to breach functional barriers, the government accommodated this gradual integration by cautiously liberalizing the foreign exchange and foreign investment controls adopted in 1949 and 1951. This policy shift was ratified in 1980 when the Diet passed the Foreign Exchange and Foreign Trade Control Law. 2/ In such an environment, Japanese policymakers face a more complicated task in striking a balance between the goals of market efficiency, prudential safety, and monetary control.

3. Canada

The structure of financial regulation in Canada has been dominated by the fundamental tension between centralism and regionalism built into the country's confederal system of government. 3/ Section 92 of the 1867 British North America Act gave the national government sole responsibility for banking and for regulation of the money supply. Despite the seeming clarity of the statute, it in fact sowed the seeds of later problems by leaving responsibility for most "near-banks" to the separate provinces. The central government quickly began exercising its statutory authority over banking and in 1871 passed the first Bank Act, an Act which since that time has been reviewed and revised approximately

1/ See Eken, 1985.


3/ For relevant background, see Neufeld, 1972; Hunter, 1986.
every ten years. 1/ The regulatory framework established by the Act was
very much a rule-oriented one which strictly defined entry conditions
and bank operating powers. The first line of defense against potential
financial instability was to be the integrity of a limited set of
broadly-based core institutions specifically authorized by Parliament to
conduct the business of banking.

Stability did not in reality come easily. The decades following
confederation were marked by both a rapid rise in the number of banks
(41 at the peak) and periodic financial crisis. Consolidation occurred
in the pre-World War I era when outright liquidations or mergers left
the system with 22 banks in 1914. The market remained regulated by the
ground rules specified in the Bank Act, but in practice a high degree of
reliance was placed on self-regulation by the industry by the industry
itself. The forum for joint stabilization of the system was often the
Canadian Bankers' Association (CBA), a peak-association which spoke for
the industry whenever a consensus among the leading banks could be
achieved. 2/ Closer governmental supervision, over the objections of
the CBA, came only in the wake of a major bank failure in 1923 when the
Office of the Inspector General of Banks was set up within the Depart-
ment of Finance. 3/ The supervisory functions of the Inspector General
were supplemented in 1935 when a central bank was established. Aside
from its overall monetary and fiscal responsibilities' the Bank of
Canada took over the role of lender-of-last-resort to the chartered
banks, a role traditionally filled by the Minister of Finance.

1/ Like Section 92 of the BNA Act, the first Bank Act failed to
provide an operational definition of banking; instead it referred to a
specific list of chartered banks and delimited entry conditions for
future additions. The narrowness of this approach left room for a
provincial role in overall financial regulation.

2/ Note that the CBA has a unique status for what is essentially now
a lobbying organization. Established by an act of Parliament in 1891,
membership was made mandatory for all chartered banks.

3/ The collapse of the Home Bank was Canada's last until 1985 when
two relatively small Alberta-based banks, the Canadian Commercial and
the Northland, failed. Between those conspicuous events, consolidation
took place mainly by way of mergers with stronger institutions.
One of the effects of the search for stability after the First World War was a further significant decline in the number of chartered banks and an attendant increase in market concentration. Limitations on market access and expanded merger activity brought the number of banks to 11 in 1925 and 8 in 1966. Simultaneously, the proliferation of other types of financial institutions—some regulated by federal and some by provincial statutes—complicated the overarching structure of the national financial system. Notwithstanding this proliferation, the degree of market concentration long held by the chartered banks has long been a matter of public policy concern. The assets represented there are in reality controlled by five very large institutions. In the mid-1980s the assets of all five approximated 85 percent of Canada's total banking assets.

The structure of domestic financial regulation in Canada came under new pressure in the 1960s. In 1963, at the behest of the federal government and in anticipation of a Bank Act renewal, a royal commission began reviewing the then-existing system, a system characterized by a variety of controls on bank operations (including controls on loan pricing) and a rigid functional segmentation of domestic financial market. Federally regulated banks, and federally or provincially regulated securities companies, insurance companies, and trust companies constituted the "four pillars" of the system and each retained exclusive access to discrete segments of the market. The Porter Commission's final report made four basic proposals for reform: that interest rate ceilings be abolished, that the powers of the chartered banks be expanded to include the ability to engage in mortgage lending, that near-banks licensed by the provinces be brought under federal purview, and that foreign banks be permitted to set up agencies in the Canadian market. The 1967 Bank Act, however, incorporated only the first two recommendations, both of which, despite some politician controversy, seemed to flow from the natural evolution of the economy and the banking system. The latter two recommendations were viewed as too radical and were therefore to be held in abeyance. The changes made by the Act nevertheless put in train pressures that gradually helped to erode traditional distinctions between the four pillars.
The 1970s witnessed a dramatic acceleration not just in the overseas growth rates of Canadian banks, but also in the pace of general financial innovation at home. With banks now fully involved in the residential mortgage market and the elimination of interest rate controls, trust companies and chartered banks became direct rivals. Further heightening competitive pressures, foreign banks began entering an ostensibly closed market through the device of provincially licensed near-banking operations, such as leasing and finance companies. Rising inflation rates, general economic turbulence, and technological developments put further pressure on the status quo. The next decennial Bank Act revision became the focus of contention between various new and established political interests. The new Act eventually passed in 1980 continued a process of regulatory liberalization by lowering functional barriers a bit more and by simultaneously legitimating the presence of expanding foreign banks and bringing them effectively under federal jurisdiction. Although the same Act placed a number of unique restrictions on the foreign entrants, including an aggregate asset ceiling, market and political pressures rapidly building thereafter encourage the federal parliament to take the unprecedented action of reopening the Act four years later in order to give the foreign banks more room to grow. Later discretionary decisions by bank regulators further reduced distinctions between foreign and domestic banks, and in 1987 bilateral trade negotiations with the United States resulted in an agreement to move to a regime of complete nondiscrimination for the major foreign participants in Canada's financial markets.

In the face of building pressures for more than piecemeal reform of outdated regulatory structures, and in the wake of serious economic instability which contributed to the collapse of two banks in western Canada, the federal government proposed a series of major changes in 1985. At the federal level, these proposals were followed by a series of influential studies on the deposit insurance system, the overall regulatory framework, and the financial supervisory apparatus. Parallel reform efforts had begun at the provincial level in 1983, especially in Quebec and Ontario and especially focused on liberalizing competitive
conditions in the securities industry. By 1987, in fact, an apparent competition in regulatory laxity had developed in this sector as provincial initiatives pushed the federal government to make accommodating moves. Barriers between banking and securities markets eroded as governments sought to deepen both and integrate them more effectively with their foreign analogues. This led quickly to most of the large indigenous securities companies being acquired by Canadian banks.

In December of 1986 the federal government attempted to rationalize the process of regulatory reform by formally proposing a comprehensive approach to the various issues at hand. 1/ Citing domestic and international pressures for change, the government proposed a framework that would permit the gradual emergence of integrated financial service companies. In the short term, that framework sought the elimination of many remaining barriers between the various domestic financial markets. At the same time, it created a new federal supervisory apparatus, broadly liberalized conditions for foreign participation in federally regulated markets, and attempted to discourage links between commercial and financial firms.

During the two decades following the 1967 Bank Act, the financial regulatory environment in Canada moved dramatically from one favoring administrative control to one providing greatly increased scope for market competition. The abolition of interest rate ceilings, the entry and expansion of foreign institutions, the lowering of functional barriers—all reflected policy decisions to give greater priority to goals of competitive efficiency. As the largest financial institutions in the country, the chartered banks seized the opportunities to expand their domestic bases in every possible direction. Although such strategies promised new rewards, they also brought new risks. While federal and provincial regulatory structures now intentionally permitted assumption of these risks, parallel supervisory structures were also reformed and strengthened in order better to monitor them and ensure

market stability. At the federal level, the Inspector General of Banks and the regulators of other federally licensed institutions were replaced in 1987 by a new Superintendent of Financial Institutions. Reporting directly to the Minister of Finance, the Superintendent was given broad powers to oversee all federal institutions and to assume direct control of institutions in trouble. To facilitate coordination across interested agencies, the federal government also established a new consultative committee comprised of the superintendent, the chairman of the deposit insurance corporation, the governor of the central bank, and the deputy minister of finance.

One of the most significant early decisions of the superintendent came in response to mounting problem loans on the books of the major banks, especially loans resulting from their overly aggressive financing of developing countries during the 1970s and early 1980s. In the summer of 1987 the superintendent forced the banks to establish provisions against possible loan losses equivalent to 35-40 percent of their total loans to 34 developing countries. These provisions led five of the six largest banks to report significant overall earnings losses for the 1987 fiscal year, for some the first actual losses in their histories. Pressure to increase these provisions further came in 1988. At the same time, the banks were strongly encouraged to begin bolstering their capital bases, a decision reinforced by the Bank of Canada's agreement with other Group of Ten central banks and bank supervisors on common minimum capital standards for all internationally active banks. For the major Canadian banks, these new supervisory policies came at precisely the time when they desperately needed unimpaired capital bases to support their expansions into new segments of the domestic market. From the vantage point of the bankers, deregulation provided new opportunities while more rigorous prudential controls rendered it difficult fully to exploit them.
4. **Germany**

In a symbiotic process, modern commercial banks and the modern German state emerged together in the latter half of the 19th century. Although private banks existed much earlier, the first German bank organized as a joint stock company was established in 1848. Both types of banks were instrumental in the promotion of industry during the years preceding the rise of Bismarck's new Reich. After 1871 Berlin emerged as the financial as well as political center of a unified Germany. Political and financial integration proceeded simultaneously and by the end of the century the major joint stock banks had set up national deposit networks. By 1918 consolidation and amalgamation left nine-Berlin-based banks in control of 66 percent of all deposits on a national basis. By the start of World War II, three grossbanken—Deutsche Bank, Dresdner Bank, and Commerzbank—dominated the national market. Political dismemberment and Occupation efforts to decentralize the financial system followed 1945, but by 1958 the Big Three had reemerged as focal points of a now more complex and variegated system. Although the pinnacle of the system remained highly concentrated and deeply interconnected with industry, a wide array of institutions existed at the local and state levels. Over 4,000 regional banks, state-guaranteed savings banks, giro (payments clearing) institutions, credit cooperatives, private banks, and other intermediaries flourished throughout the extended post-war economic boom. 1/ As a result, in the early 1980s the largest commercial banks, most of which were now based in Frankfurt, accounted for only 8 percent of total business volumes in the financial sector of the Federal Republic. 2/

Over time, the major German banks evolved into "universal" financial institutions capable of undertaking a wide range of business activities, including deposit banking, commercial lending, mortgage

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1/ See Wilson, 1986, 151-161.
2/ Deutsche Bundesbank, Monthly Reports. This figure somewhat understates the influence of the Big Three, given their traditional and continuing dominance in the spheres of industrial lending, foreign lending, and foreign trade financing. See Stein, 1982.
lending, securities underwriting, and equity ownership in nonfinancial industries. Unlike the experience of the United States, Japan, and Canada, these business powers were not rescinded in the 1930s and German banks have therefore never had to adapt to a system of functional segmentation. With the notable exception of the World War II period and its aftermath, direct governmental controls in this sector have generally been kept to a minimum. As in other countries, however, banking in the Federal Republic is a regulated industry, and the overarching regulatory structure during the postwar period has been a rule-based one. Unless an activity is explicitly forbidden, the presumption is that it is permitted. Governmental policy typically gives the benefit of the doubt to "market" forces.

Currently, the legal framework for the system is specified in the 1961 Banking Act and its subsequent amendments. In general, the Act makes it very easy to establish new banking ventures and provides an unusually broad definition of banking. For the national banks, the basic regulatory agencies are two: the West Berlin-based Federal Bank Supervisory Office (an independent arm of the Finance Ministry) and the Frankfurt-based Bundesbank. Roughly speaking, the Supervisory Office is responsible for licensing, enforcing the system’s minimal rules, general prudential monitoring, and overseeing matters affecting institutional solvency. The Bundesbank, conversely, focuses on liquidity issues associated with monetary policy and serves as a lender of last resort.

In practice, self-regulation has long been the norm for major banks in most areas of their business. In recent years, however, partly in response to the spectacular failures of two private banks (I.D. Herstatt in 1974 and Schroder, Münchmeyer & Hengst in 1983) and partly in connection with European Community and G-10 harmonization efforts, the Supervisory Office and the Bundesbank have been moving toward tighter and more explicitly articulated rules regarding capital adequacy,
liquidity, lending limits, and accounting rules. But such changes more often than not result from processes of bargaining and negotiation in which the banks' peak association, the Federal Association of German Banks, plays an important role. "Gentlemen's agreements" have been common, both between the major banks themselves and between the banks and their regulators. One such agreement, for example, created an effective domestic oligopoly over the deutschmark denominated bond market that served to prohibit foreign dealers from leading bond issues floated within Germany. Both because of the banks' collective dominance of domestic underwriting activity and because of German industry's historical reliance on bank loans, indigenous bond and stock markets remain underdeveloped in relation to analogues in, for instance, the United States or Great Britain.

Very recently, the competitive imbalance between indirect and direct financial markets within Germany has been shifting. Partly in reaction to regulatory innovations in other countries, notably Britain, and partly in an effort to secure reciprocal rights for German banks abroad, German regulators have attempted to encourage deeper and broader competition in domestic securities markets. Most prominently, the Bundesbank took the initiative in 1985 to allow foreign bank subsidiaries to lead new domestic bond issues. At the same time, reversing a longstanding ban, the central bank permitted the introduction of several innovative underwriting techniques developed in external bond markets. The bank also convinced tax authorities to repeal a coupon tax on foreign purchases of domestic bonds that had the effect of stifling investment and shifting attractive business off-shore. In subsequent

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1/ See Friesen, 1986. Note that accounting rules, as well as tax conventions, have traditionally encouraged the building up of "hidden" reserves (mainly through the undervaluation of assets) which are assumed to bolster confidence and smooth out earnings fluctuations.

2/ According to John Zysman, "The power of the German banks in industrial affairs rests on two pillars: their market power over the sources of finance for industry, and their legal right to own substantial stock in corporations and to exercise proxy votes for other shareholders." Zysman, 1935, 251-265.
moves, the Bundesbank, the federal government, the major banks, and the principal German stock exchanges reached agreements on the development of entirely new domestic markets for such sophisticated financial instruments as financial options and futures.

While all of these pro-competitive moves have been taking place, potentially countervailing developments have been occurring in the area of bank supervision. Since the late 1970s, the freedom of German banks to underwrite, resell, or hold voting shares in industrial concerns and to appoint directors to corporate supervisory boards, has been under direct political attack on conflict-of-interest grounds. A governmentally sponsored enquiry publicly examined associated issues in 1979, but recommended only minor reforms. 1/ In 1982 the same issues resurfaced in during a federal election campaign, but again no structural reforms resulted. Material changes did occur, however, in 1983 when one of the country's largest private banks collapsed because of overly aggressive lending to a troubled industrial client. Supervisory authorities subsequently pushed through the Bundestag important amendments to the Banking Act designed to tighten prudential standards and broaden the scope of official surveillance. One amendment, for example, made it necessary for German banks to consolidate and report assets and liabilities of 40 percent owned affiliates (formerly only 100 percent owned subsidiaries had to be consolidated in parent bank balance sheets); other amendments lowered ceilings on total loans to individual clients from 75 percent of a bank's capital base to 50 percent. 2/

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The gradual tightening of the supervisory regime for German banks received a significant impetus from debt repayment difficulties experienced by Poland beginning in 1981. Like the position of American banks with respect to Latin American debt, German banks accounted for a disproportionate share of all foreign lending to the governments of Poland and other East European countries. As of 1984, for example, German banks held only 6.4 percent of commercial bank lending to Brazil, 4.8 percent of loans to Mexico, 19.5 percent of the Soviet Union's debt, and 16.5 percent of Yugoslavia's debt. 1/ Over the three years following Poland's 1981 default, German bank supervisors encouraged the banks to write down their Polish portfolios. 2/ A changing regulatory environment within Germany and within the European Community more generally, subsequently reinforced a strategic retrenchment on the part of the banks.

1/ Friesen, 1986.
2/ In subsequent years, new lending to developing countries remained on a generally downward trend, albeit with certain regional exceptions. See Mark Allen, et al., April 1989, Table A32.
IV. Conclusion

The relationship between the structure of a nation's financial system and the performance of its economy is as profound as it is subtle, and the complexity of that relationship increases as international integration deepens. Although the direction of causal influence is not one way, governments commonly perceive a potential macroeconomic threat from financial market instability and a potential opportunity for enhanced macroeconomic performance from financial market development. Under conditions of interdependence, governments therefore confront incentives both to cooperate and to compete with other governments in creating environments conducive to the stability and growth of markets under their purview. In principle, mechanisms for advancing competitive impulses are relatively straightforward; governments have it within their power to regulate or deregulate, tax or subsidize, open or close the markets they oversee. As those markets become more deeply integrated, however, mechanisms for cooperation, unavoidably intergovernmental in character, become more difficult to create just as they become increasingly necessary. As financial markets expanded during the 1970s and 1980s, a disjunction became evident between the transnational logic of economic integration and the continuing reality of decentralized political authority. In the absence of clear international governing arrangements, potentially dangerous regulatory gaps threatened to open and distort competitive conditions to the detriment of global economic welfare.

Internationally linked financial markets and the continued responsibility of national political authorities for both market stability and macroeconomic management have highlighted a need for greater intergovernmental coordination in the financial sector. Against a backdrop of theoretical and practical issues raised by the relationship between financial structure and macroeconomic performance, as this paper has discussed, governments have during the past two decades made noteworthy efforts mutually to adjust aspects of their respective financial supervisory policies. It may even be argued that through those efforts
loose international supervisory arrangements are beginning to emerge, arrangements that seek to balance the cooperative and competitive impulses of those governments. Although still at an early stage, such arrangements could presage more permanent mechanisms for stabilizing financial markets, enhancing long-run efficiency, reducing risks to macroeconomic performance and facilitating continued integration. At present, however, these informal arrangements are rendered tenuous by deep structural differences that continue to characterize national financial systems. Resulting collective action problems remain evident.

In recent years, some progress has been achieved in resolving such problems at the micro level. Mainly in response to potential or actual financial crisis, that progress has taken the form of policy harmonization on the basis of consensus achieved in official discussions. While the impact of such work as that of the Basle Committee of Bank Supervisors (on the division of supervisory responsibilities between home and host states and on capital adequacy standards for banks) is significant, it is enlightening to note that actual policy harmonization has mainly been achieved in small technical groups able to shield themselves from the broader currents of national and international politics. In contrast to such progress, however, on the key macro concerns that lie behind the fundamental interests of states in financial markets, the connection between financial deepening and macroeconomic stability and growth, there is an absence of reliable and adequate mechanisms for promoting policy coordination. Aside from tax treaties and vague summit communiqués, the most states have generally shown a willingness to do in this area is to consult with one another on an "ad hoc," mainly informal basis.

As linkages between national financial markets continue to deepen, the need for regularized and institutional supervisory coordination at a broader level would appear to be rising. But the core dilemma here remains what it has always been. States, sometimes competing with one another and sometimes amenable to cooperation, remain the final arbiters
of international finance. And especially in extremis, states tend to place national concerns and competitive impulses ahead of international accommodation. To be specific, at the international level, the persistence of an institutional void in this area threatens global stability in at least two ways. Firstly, a competition in policy laxity may be encouraged by governmental competition for, among other things, the jobs and prestige associated with the financial sector, and by the propensity of intermediaries to engage in regulatory arbitrage. Secondly, as financial markets become more integrated geographically and functionally, intermediaries may take on too many of the wrong kinds of risks because they believe themselves ultimately to be protected by implicit official guarantees. Multilateral institutions, such as the IMF or an expanded OECD, might usefully be called upon to play a more prominent role in ameliorating such dangers. In such fora, the fundamental connection between technical financial matters and larger issues of macroeconomic management might be made more obvious.
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