The Domestic Politics of Financial Globalization

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Abstract

This paper seeks to ground financial regulatory choices in domestic politics. International competition in financial services has not produced the regulatory "race to the bottom," we argue, because politicians would rather dismantle banking cartels than to risk financial instability at home. Despite the homogenizing effects of global financial integration, moreover, domestic political institutions continue to shape the nature and extent of prudential regulations that countries adopt in the place of banking cartels.

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1. Introduction

Financial liberalization differs from trade liberalization in this important respect: unilateral deregulation benefits the deregulator because it pulls business from abroad. In trade, a lone liberalizer may be hurt if other countries enjoy its open markets without reciprocating.[1] In finance, by contrast, countries that don't follow the lead of liberalizers run the risk of losing investors and borrowers to the countries where prices of financial services are lower. This logic, it would seem, unleashes a dangerous "race to the bottom" among financial regulators of the world.

In actual practice, we do not observe a downward spiral of competitive deregulation. Global integration among national markets has increased competition in financial services, to be sure. But in the place of market restrictions that once kept many national financial systems afloat, governments the world over are strengthening prudential rules such as capital requirements and mandatory disclosure. Why, when there is some reason to expect a "race to the bottom," do we observe increased prudential regulation? Second, why do we observe continued variation in the level of both competition and prudential regulation among industrial democracies?

It would be tempting to conclude that there is a strong regime in international finance that is holding the line on competitive deregulation. Perhaps the Basel Committee for Bank Supervision, with its recommendations for capital adequacy, risk management, and supervisory standards, is the response of anxious bank regulators to arrest this inevitable slide to irresponsible banking. An epistemic community of like-minded government officials comes to the rescue of market forces out of control.

An empirical review of recent history suggests instead that governments began strengthening prudential rules before the Basel Committee or the International Organization of Securities Commissions (IOSCO) had done anything about them. Our answer to this puzzle lies in the domestic politics of finance. Transborder banking services forced governments to choose between continued protection of domestic banks and the interests of businesses in better investment and borrowing opportunities. Most, for domestic political reasons, chose the latter. In doing so, however, they had to find some other means of protecting depositors from the possibility of financial meltdown. A competitive financial regulatory framework with accompanying prudential measures, though the second choice for many countries, has become the dominant one.[2]

This answer reveals a paradox: banks can be politically too strong for their own good. Banking, like any sector, wants a cartel which would guarantee profitability. If it is politically strong enough to get one, it may end up driving away business, at least from customers with cross border mobility. We predict, then, that the "race *from* the bottom" in prudential measures aims primarily at mobile capital which is searching for

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[1] Unilateral opening may eventually make everyone better off, as classical trade theory asserts, but strategic trade theory is more in line with the domestic politics of trade's distributional consequences.

[2] Note that this argument differs from the "California effect" where countries adopt U.S. standards because they want to be able to sell financial services in the U.S. market. (Genschel and Plumper, 1997; Deeg and Luetz, 2000).

competitive markets. Small depositors and borrowers may be left out of this competition. In other words, political institutions, which channel and constrain the choices governments make, allow for considerable cross-national variability. We find that this variation is well explained by resort to electoral systems as a primary explanatory variable.

This brings us to a third question. What are international banking regimes doing, if not preventing a race to the bottom? In this paper, we examine the Basel Committee for Banking Supervision's recent efforts to harmonize capital requirements across member governments. In June 1999, the Basel Committee issued a Consultative Paper which revises the Basel Accord of 1988, with the intention of matching capital requirements more closely to the underlying risks of bank portfolios. In so doing, the Basel Committee requires national bank supervisors to alter substantially their tried and true methods of regulating their respective banking industries. Particularly given the importance of banks to other aspects of any given domestic economy, how, we ask, can a transnational body of central bank officials pull off such a power stunt? It does this, moreover, without penalties for noncompliance.

Our argument is that they provide a service in helping market leaders and market followers to converge on an equilibrium outcome. For the Basel Committee in particular, where the voting rule is unanimity (everyone has a veto) and compliance is voluntary, everyone has to be satisfied that the negotiations produce a better outcome than the status quo. The power among the countries in the Committee depends on their reversion points in the event that the negotiations fail. Although, as we argue, the regulation of banking theoretically has multiple equilibria, the market is converging on an equilibrium that combines elements of the American, British, and in some cases, Continental styles of regulating.

The rest of this paper is organized as follows. The next two sections discuss why banking tends to be heavily regulated, and how domestic politics have shaped the form of regulation in four financial powers, the U.S., Japan, Germany, and the UK. Section Four removes the closed economy assumption and shows how international competition in financial services has undermined profit padding regulation as a politically viable option. Section Five summarizes the harmonization efforts of the Basel Committee for Bank Supervision and the International Organization of Securities Commissions in the wake of growing international competition in financial markets. Section Six provides a reality check for our argument by looking closely at the politics of regulatory choice in a country that had far to go in adopting prudential regulation: Japan. Section Seven concludes.

2. How Banking is "Special"

The alchemists had it wrong: you can't make gold out of base metals. But as any banker knows, making money in the banking business hinges on a few intangibles that can seem almost as magical and mysterious: information and judgment about credit risks, depositors' trust in the bank, and the time value of money. With the right ingredients, banks can transform savers' short term deposits into long term loans, pay interest on the depositors' savings, and make money for itself to boot. But if bankers make too many bad loans, or even if depositors only suspect that they have, depositors may rush to retrieve their savings. Because maturity transformation doesn't work in reverse—you can't short term pay accounts payable with long term accounts receivable—the whole banking system can choke up in a massive liquidity crunch in a single afternoon. If that elusive trust of savers evaporates, regulators have a liquidity crisis on their hands, or worse. Even healthy banks can fail under panic conditions (Diamond and Dybvig 1983).

Asymmetry of information and the fragility of trust constitute a colossal market failure waiting to happen. Depositors' relative lack of information about what banks do with their money gives bankers an incentive to make riskier loans. This is because the upside gains from risky loans are potentially large while the limited liability of shares reduces downside risk (Merton 1977). Of course, depositors generally do not need to worry about such matters because deposit insurance places the moral hazard of this situation squarely on the shoulders of government.

The banking industry cries out for public intervention of one sort or another. In the absence of deposit insurance a suboptimal allocation of capital will arise as wary savers stuff their cash into mattress covers. If the government has extended deposit insurance, prudential regulation is required to forestall, or at least limit, the potential downside for the government. The problem for regulators is that there is no single optimal way to regulate banking (Bhattacharya and Thakor, 1993:31). In the absence of deposit insurance, requiring strict disclosure, at a minimum, would force banks to pay depositors a rate that matches the riskiness of the bank's loan portfolio. But discriminating among banks is likely to be costly for the average saver. Trying to protect depositors with mandatory deposit insurance, on the other hand, creates moral hazard all over again because such schemes tend not to be related to risk. With fixed insurance premia, the value of insurance increases with the riskiness of the loans. A bank can potentially make higher profits on riskier loans, but if, in the worst case scenario, the loans are not repaid and the bank fails, the deposit insurer will pay the depositors. As we saw from the U.S. S&L fiasco in the early 1980s, banks that are already in financial trouble can be tempted to "gamble for resurrection" provided that deposit insurance limits their liability to depositors (Fratianni, 1995: 148-149).

Mandatory disclosure and insurance are at the minimalist end of the regulatory spectrum and figure prominently in economics textbooks concerned with efficiency. In the next section, we explore the rules national regulators have adopted that range from minimalist to highly interventionist.

3. Banking Regulation and Domestic Politics

Government regulators can be counted on to mix political objectives with efficiency concerns anyway, but the absence of a textbook blueprint for optimal banking rules makes for a varied assortment of domestic banking structures, worldwide. There are numerous ways to guard against bank runs, and the trade-offs that regulators make in choosing one type over another have important consequences for groups of domestic constituents. This section explores how domestic politics in industrialized democracies shape those trade-offs.

Regulating the banking industry requires specialized knowledge of finance and corporate governance, and therefore democratic governments typically delegate the task to bureaucratic experts. That is not to say, however, that legislators don't care about the results. The political process is usually quite explicit about the policy boundaries within which the bureaucrats are to manage the banking sector. At a minimum, politicians want to avoid bank runs that rob voters of their savings, or more likely, require the government to draw on deposit insurance. Such events could lead to voter wrath on a scale that would threaten the political life of legislators. Politicians will therefore be likely to err on the side of bank system safety, even at the expense of efficiency and the moral hazard problems that make economists cringe.

Politicians may also be inclined to use the banking system to promote other political goals, such as cheap financing for favored constituents or pet development projects or protecting labor. Politicians' incentives for how and how much to manipulate the banking industry are much like the incentives politicians face for how interventionist to be more generally. On the demand side, they depend on the collective action capabilities of banks, bank clients, and labor. On the supply side, they depend on how partisan platforms are aggregated by electoral rules and legislative institutions, and how they are implemented by the administrative process.[3]

All else equal, banks have a collective action advantage over the average depositor and we should expect regulation to mirror that by transferring wealth from depositors to banks (Stigler 1971; Peltzman 1975). At that pre-institutional level of analysis, we can expect variation in banking regulation depending on how well the corporate sector or labor can compete with banks for public favor based on their collective action capabilities. Only by looking more closely at domestic political institutions can we also learn the conditions under which the government will choose to subsidize the collective action costs of depositors and other poorly organized groups.

3.1 Political Institutions and their Policy Consequences

Political systems vary along more institutional dimensions than we can elucidate fully in this paper. We focus here on only the few that most strikingly differentiate four financial powers: The U.S., UK, Japan, and Germany. We will examine how political institutions create a policy bias that may have bearing on financial regulation in these four countries. Later we will look at some of these trends statistically using the larger domain of industrial democracies.

In the U.S. and UK, single-member district electoral rules force politicians, all else equal, to care about the interests of the voters in the middle of the political spectrum.[4] These electoral rules should push banking regulation toward the interests of the general public. The U.S.'s presidential system produces weaker political parties than the UK's parliamentary system, however. Political fragmentation in the U.S. creates more

[3] We are using the terms "demand" and "supply" here analogously, to refer societal pressures on the one hand, and on the other, the government's decision making apparatus that filters those demands. See Tirole and Laffont (1991: 1090).

[4] All else is not equal, of course, and the stronger organization of labor in the UK gave the Labour Party a more leftist leaning. This has changed somewhat recently when the Labour's parliamentary caucus changed the party constitution to weaken labor's control over the candidate selection process.

channels of access to government power. On the negative side, tension between the executive and legislative branches in the U.S. reduces the legislature's inclination to delegate substantial regulatory powers to the bureaucracy.

Japan and Germany are parliamentary systems like the UK but their respective electoral rules endowed politicians with different sets of political incentives. In Japan until 1994, multimember electoral districts forced politicians of the same party to compete against one another for reelection. To oversimplify for the sake of clarity, this forced politicians to adopt a niche strategy whereby they sold favors to a particular industry in exchange for campaign contributions with which they ran electoral machines. As a potentially profitable industry capable of bankrolling politicians, banks should be one of the beneficiaries of this niche strategy.

In Germany, a combination of single member districts and closed list proportional representation brought a more majoritarian slant to the policy making process than in Japan. But in Germany both large parties courted organized groups of voters, primarily labor, to help turn out the vote for the PR list. We should expect interest groups, like labor in Germany or small retailers in Japan, efforts to be rewarded in the regulatory process.

3.2 Types of Financial Regulation

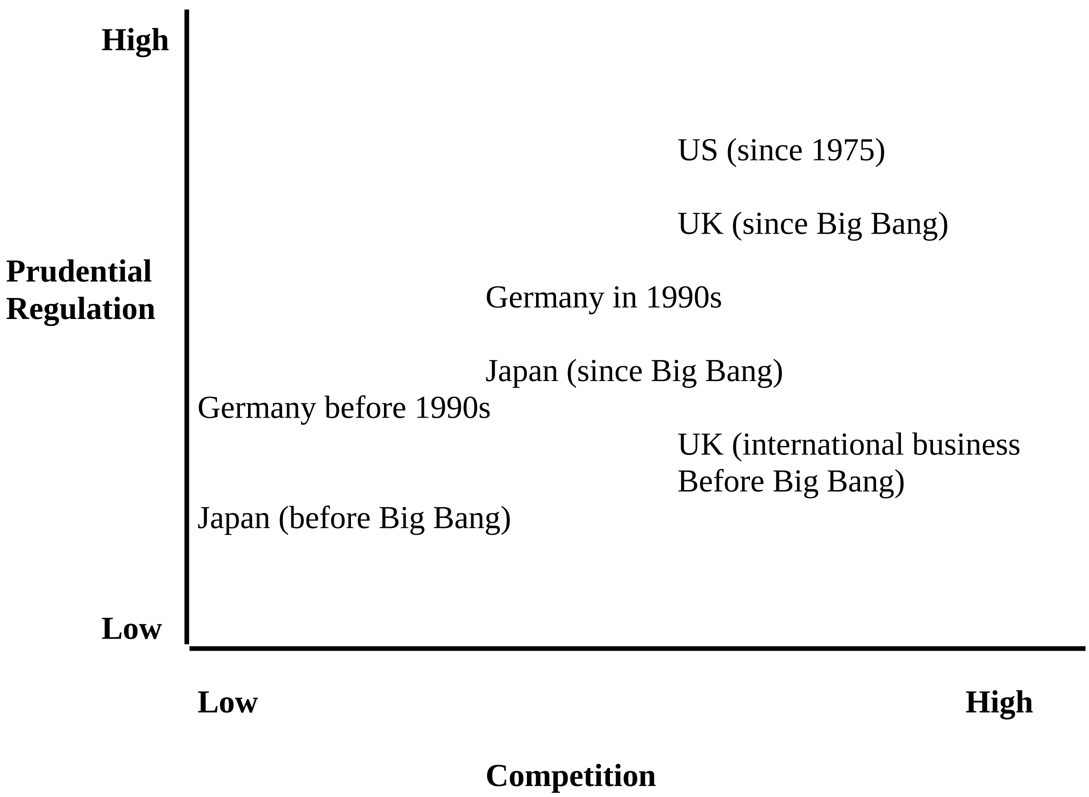
Jumping now from theoretical expectations to empirical observation, we notice that banking systems of the industrialized world can be roughly divided into two types. **Prudential** regulation imposes the costs of system stability on the financial institutions themselves, by, for example, forcing banks to hold reserves as a cushion against bad loans and to limit loans to some specified multiple of paid-in capital.[5]

Profit padding regulation, on the other hand, foists the costs of system stability with taxpayers and consumers of financial services, by limiting the competition among financial institutions. Whereas prudential regulation may coexist along with or in the absence of market competition, profit padding requires that financial institutions not compete away their profits. Borrowers pay more for loans, depositors get less money on their deposits, and taxpayers stand ready to bail out ailing institutions. In exchange, depositors are guaranteed safety (think of below-market interest rates on savings accounts as a hefty insurance premium) and bank employees are more likely to keep their jobs over the long run. We know that government guarantees against bank failure can be an invitation to make risky loans without penalty. Three influential economists have recently argued that the reverse is also true: too *much* competition inclines banks to gamble because lower profits shorten the time horizons of bank owners and managers (Hellmann, Murdock, and Stiglitz, 2000: 148). Because of the inherent trade-offs involved, there are theoretical grounds to justify or impugn almost any banking regulatory system. Our argument is that governments adopt any given combination of rules on account of distributive political concerns rather than from calculations of economic efficiency.

[5] Milne and Whalley (1998: 8) describe capital as "a form of self-insurance against poor asset returns, with the bank retaining earnings in order to build up capital reserves towards a desired level and so reduce the probability of losing ownership of the future profit stream."

Most financial regulatory systems cluster into one of these two categories. But they actually rest on two underlying continuums. First, financial regulatory systems run the gamut from competitive to profit-padding varieties. Second, the prudential regulatory dimension runs from low to high. Specific policy choices can affect either dimension without altering the remaining dimension. As we show in the next section, increasing competition in international finance has forced a global shift towards prudential regulation. This has meant the most substantial change in regulatory style for countries such as Japan that once relied principally on market restrictions to keep the banking system afloat. Markets that were already competitive, such as the wholesale business in London, have become more prudential as well.

Figure 1: Two- Dimensions of Regulatory Choice



Depending on the domestic politics of each country, moving simultaneously towards greater competition and tougher prudential rules can be highly contentious. Grasping the political equilibrium in each nation, which we see as the trade-off politicians have made between having a competitive or profit-padding regulatory regime, helps us understand the compromises that underpin international regulatory agreements. In this next section, we examine the politics of banking in four financial powers prior to global market integration beginning in the 1960s and 1970s. We will return to this issue and connect the arguments to data in final section.

3.3 U.S. Postwar Banking Regulations.

U.S. banking regulation is not pretty. Most idiosyncratic about the U.S. banking system is the extreme fragmentation of market niches and of regulatory oversight. The Office of the Controller of the Currency (OCC) within the Treasury Department charters and oversees national banks. The Federal Reserve System oversees all bank holding companies and shares responsibility with the states for state banks that are members of the Federal Reserve. The states and the Federal Deposit Insurance Corporation share responsibility for the vast number of state banks that are not members of the Federal Reserve System. And that is just for banks. The Securities Exchange Commission continues to regulate the issuance and trading of stocks and bonds even though the regulatory wall between banks and securities firms is coming down.

Some scholars have focused on the inelegance of this regulatory fragmentation (Cerny, 1994: 425 ff.). On the positive side, financial institutions without an overarching enforcer are unable to maintain cartel like behavior, at least for very long. Over time, most profit-padding features of U.S. banking regulation have fallen to the competition that emerges when no single regulator can maintain the peace among different sorts of financial institutions. In one well known case when S&Ls enjoyed a bit of profit padding regulation—interest rate ceilings—money market funds lured away a large portion of their depositor base. S&Ls wanted money market funds to be barred somehow from doing this, but the respective regulatory bodies did not help the two industries collude and the result was continued competition between savings deposits and money market funds at a break neck pace. The S&L fiasco ended up costing taxpayers a bundle of money when many of them failed, but that industry was eventually cleaned up and competition continues, along with capital rules, regulatory supervision, and deposit insurance, to characterize American banking.

This regulatory fragmentation in banking reflects the relative dispersion of political power in the United States, where the legislative and executive branches compete for policy control and where federal and state governments share jurisdiction over many aspects of economic policy. Single member electoral districts for both the House and Senate insure the stability of two large political parties and a general orientation towards the middle of the political spectrum. But sharing power with a strong presidential institution translates into highly specific legislation and a rule-based system of regulation. The overall result for finance is that regulators have relatively little discretion in their oversight responsibilities, and rules are not particularly skewed towards the interests of financial institutions.[6]

Despite the collective action advantage of banks, the institutions of American government largely countervail their position of political strength. There are too many levels of government at which corporate interests can be checked. More importantly, electoral incentives force politicians to pay attention to diffuse (read consumer) interests to a greater extent than in countries that use more proportional electoral systems. Prudential banking regulations such as capital requirements, reserve provisioning, and disclosure rules impose many of the costs of bank system stability on banks themselves.

[6] This is true only in a comparative sense. If the OCC had not taken liberties with Congress's mandate under the Glass Steagall Act, U.S. banks would not have been able to gain a foothold in the securities business as early as they did. On the other hand, banks might have lobbied earlier and harder for Glass Steagall's repeal.

So pitiful did American banks appear in their lack of political power that, in the late 1980s, some observers feared that the sector was destined for the international backwaters.

3.4 Japanese Postwar Banking Regulations

The postwar Japanese banking system has occupied a spot far closer to the "profit padding" corner of the matrix. Although financial behemoths coexisted with tiny savings institutions, large and small benefited from fond government attention and cartel-like regulation that limited the price competition for deposits. At least until the Euromarkets began siphoning off corporate customers in the mid 1970s, stiff entry barriers and walls between different types of financial institutions also muted competition for borrowers. This was the famous "convoy" system of banking regulation, in which the Ministry of Finance kept innovation and competition to a slow enough pace that even the smallest of financial institutions could survive. The MOF prided itself on not letting a single bank fail.

During much of Japan's postwar history, banking was the most profitable sector in Japanese industry. It was also the most influential. By rationing funds to favored customers and holding their stocks, banks shaped corporate growth strategies and restructurings (Calder 1993).

Underlying Japan's bank-nurturing regulatory policy was a political system that gave politicians strong incentives to curry the favor of producer groups. Partly to blame were the multimember district, single non transferable vote (MMD, SNTV) electoral rules for the more powerful Lower House, in which two to four representatives were elected from each district. Any party seeking to gain or maintain a legislative majority had to field multiple candidates in most districts. The resulting intra-party competition for votes and campaign funding led majority party politicians to cultivate personal support networks (*koenkai)* at the expense of a coherent party platform that tried to make sense of issues. Instead of appealing to voters on the basis of ideas about the public good, politicians busied themselves selling regulation to industries, including the banking one, and using that money to curry favor with voters back home. Banking regulation, bought and paid for by the banks, ensured smooth transmission of savings into industry as long as long as banking remained profitable.

3.4 German Postwar Banking Regulations

Germany, like Japan, has protected depositors from bank failure by protecting banks from "excessive" competition. A 1967 law sets limits on interest rates for deposits, and establishes barriers to entry for new financial institutions or new branches of old ones (Oberbeck and Baethge, 1989). The German banking authorities also require banks to keep loans within a reasonable multiple of capital (otherwise known as capital adequacy requirements, which are a form of prudential regulation). But the German accounting practices are more lenient so that 8% capital in Germany, say, would be discounted by a few percentage points if measured by U.S. standards.

Also like Japan, Germany has a long tradition of bank-centered finance. In addition to their lending role, banks hold large equity shareholdings of German companies. This is in part thanks to a high capital gains tax that makes the selling of shares prohibitively expensive for the banks. As a result, banks have an incentive to cultivate long term, stable relations with their corporate customers, and, in turn because of this stability, corporations are able to hold employees through thick and thin.

The laws that give banks these incentives are no mistake. Labor is highly organized in Germany, has strong representation in the SPD, and even controls a wing of the CSU on the right. In 1982 when the CDU-CSU government attempted to roll back some protections for labor, it received an electoral drubbing in the next laender elections and backed off. Given the substantial influence that labor has in the political system, it is not surprising that banking regulation in Germany reflects, at least partially, labor's interest in employment stability. In fact, most organized groups' interests are well represented in German regulatory policy, banks and industry as well as labor. Ordinary depositors (and perhaps notions of efficient allocation of capital), again as in Japan, are the losers in this system.

A second feature of the German banking system of comparative interest is its strong federal character. Contrary to the image of centralized bank control of the economy that Gerschenkron and Schonfield (1965) have given us, the influence and role of German banks varies considerably by federal state (Herrigel 1998; Deeg 1999). Land governments own substantial shares in regional banks and use the loans from these banks to promote the interests of small and medium sized businesses in their Land. Even in North Rhine-Westphalia, where big business dominates the local economy, the state bank (WestLB) and savings banks support the technology acquisition and R&D of small firms at subsidized prices (Deeg 1999). Commercial banks, not surprisingly, are unhappy about the "profit padding" of state banks that gives them an unfair advantage. This conflict is likely to sharpen if large firms increasingly go outside Germany for cheaper and more flexible funding, leaving big commercial banks to go after (less mobile) small and medium sized borrowers.

3.5 U.K. Postwar Banking Regulations

Postwar financial regulation in the UK is a tale of two cities—or more properly, of metropolis and town. On the one hand, the City of London in the UK was a player in global financial markets a hundred years ago when banks in other countries were just upstarts. So profitable were these global lenders and investors that successive British governments saw fit to leave them well enough alone, provided that they didn't cause trouble at home. The internationally active financial institutions monitored themselves and, in exchange, were spared institutionalized government oversight and legal sanctions. They didn't ask for profit padding, but nor were they saddled with prudential rules not of their own making (Moran 1991).

Alongside highly competitive international markets were domestically oriented institutions, primarily in the retail banking sector. These, the Bank of England supervised with a range of restrictive practices and protection that padded their profits (Moran 1991: 56). As in the U.S., Japanese, and German cases, the British government allowed these banks to charge depositors inflated prices for bank services in exchange for staying out of trouble of bank-failure proportions. Because foreign transactions were walled off from domestic markets, however, the government was able to accord different treatment to non-voting investors. The government seemed to be saying, "Get them over here for their business, but then let them fend for themselves since they can't vote us out of office."

This brief overview of how four governments regulated their banking markets sets the stage for assessing how, and to what extent, depositor and investor protections came to be adopted, and who bore the costs for these. In particular we intend to contrast the role of supra-national organizations against their varied impact in light of domestic political incentives.

4 The Basel Committee, IOSCO, and EU Directives

A number of scholars have studied organizations for regulatory harmonization for clues about the nature of the "regime" in international finance: is it characterized by each country out for itself, or by like-minded regulators acting in common purpose to prevent financial disasters on a global scale? (Kapstein 1989, 1996; Helleiner 1996; Luetz 2000). Our level of analysis, on domestic actors, leads to a somewhat different set of questions. How do governments manage the contending domestic interests in global financial competition? Does domestic politics hasten, or modify, the international regulatory "race to the bottom"? We begin with a discussion of the most prominent international organization dealing with banking regulation, the Basel Committee for Bank Supervision.

4.1 The BIS and The Basel Committee for Bank Supervision

The Bank for International Settlements was established in Basel, Switzerland in 1930 as a conduit for managing war reparations and later as a location for central bank cooperation. It is ironic that many at the 1944 Bretton Woods conference felt that the BIS no longer had a place in international monetary matters and should therefore be liquidated, for the institution has outlived Bretton Woods itself (Helleiner, 1996: Fratianni and Pattison 2000: 14-15). For our purposes, the most important function of the BIS today is its role as host and secretariat for the Basel Committee on Banking Supervision, which was established in 1974 by G-10 central bank governors in the wake of the failure of Herstatt Bank (Fratianni and Pattison, 2000: 19-21).

The Basel Committee is made up of representatives of the ten G-10 countries plus Luxembourg, but over 100 countries voluntarily adopt the 8% capital adequacy rules that the Committee agreed upon in 1988 to shore up the equity cushions of internationally active banks (Hideshima 1999: 4; Porter 1993: 57). For that matter, compliance is voluntary for the member countries themselves. How can a body hobbled by unanimity rules and voluntary compliance be responsible for such spectacular success?

The answer, as we have argued, is that governments around the world face a choice between 1) protecting banks from competition and thereby robbing domestic firms of access to globally priced financial services; or 2) allowing its borrowers and investors to shop for the best prices and thereby weakening the profit-padding regulation that undergirds financial stability in most countries. Governments typically make the second choice, so rarely do banks outweigh the entire industrial sector. In making that choice, though, governments need to find prudential alternatives to their old rules. The Basel

Committee provides a view of what those prudential rules should be—weighted by the disproportionate strength of financial markets in the U.S. and UK.

It was only a few years ago, of course, that the financial power of Japan seemed poised to eclipse that of the U.S. and the UK. Worried that Japan was subsidizing the overseas operations of its banks through profit padding regulations at home, the U.S. and UK signed a bilateral deal in 1986 that required banks to comply with 8% capital-asset ratios or be cut out of their markets (Oatley and Nabors, 1998; Kapstein, 1996). The following year, the Basel Committee, including Japan, put its blessing on this bilateral deal with a Basel Accord, to be implemented by member countries gradually from 1991 to 1993.

Why did Japan comply? In the first place, Japan was accommodated. The compromise hammered out in Basel allowed Japanese banks to count 45% of their unrealized profits from stock holdings towards 4% of the 8% target. In those heady days of Japan's asset boom, Japan's banks would make 8% under those conditions easily. Once Japan's asset bubble burst and stock prices bottomed out, Japanese banks found themselves short of the target. Why didn't Japan back out then? Our answer lies in domestic Japanese politics. Japanese corporate borrowers and investors do not want to pay for a bank cartel at home when there are already efficient financial markets and liquidity abroad. Japanese voters do not want to pay to prop up banks with any more tax money and regulatory forbearance than they have already delivered. Any Japanese government calling a moratorium on capital flows for the sake of ailing banks would have lost public support immediately. This was particularly true in the context of public anger over the excesses that banks and other financial institutions had indulged in during the bubble economy of the late 1980s.

In more general terms, capital adequacy rules are adopted worldwide, even if it hurts, not because there is a compelling economic argument for capital rules as opposed to other financial regulation. They are adopted because these rules, unlike profit padding rules, are compatible with the increased competition in the financial markets. Domestic investors and depositors must access money at the best available prices or lose out to foreign competition; and banks must meet those competitive standards or fail.

4.2 1999 Consultative Paper

In June 1999 the Basel Committee issued a new Consultative Paper, designed to improve the way banks manage risk. In the ten or so years since the Basel Accord was adopted, the securitization of banking markets, especially in the U.S. and UK, made some aspects of the 8% rule less relevant to the underlying riskiness of bank portfolios. Bankers were exploiting differences between economic risk and regulatory requirements wherever they could find those differences: they would choose the economic risk if that required less capital, or the regulatory requirement where that required less. The result of this regulatory arbitrage was an erosion of bank capital.

The Basel Committee and its various subcommittees are still, at this writing, in the process of drafting the documents for amending the 1988 Basel Accord, but the broad outlines are clear. The Consultative Paper explored ways to match capital requirements more closely to the underlying risks of financial institutions' portfolios by way of three "pillars". Pillar I, which deals with capital requirements, introduced the possibility of banks using their internal risk ratings systems to determine how much capital to set aside. Pillar II, bank supervision, and Pillar III, market discipline through adequate disclosure to allow for meaningful external ratings, supplement the capital rules.

4.3 IOSCO

IOSCO is the equivalent of the Basel Committee for the securities industry. In 1974 the World Bank and the Organization of American States founded the Inter-American Association of Secu`rities Commissions and Similar Organizations, to assist in the development of securities markets in Latin America (Steil, 1994: 198). Later renamed the International Organization of Securities Commissions (IOSCO), this organization has in the last decade become an organization with international membership and global concerns.

Unlike the Basel Committee for Bank Supervision, which has retained a club-like organization, IOSCO has over 100 regulatory and self-regulatory members, most of which can vote on policy proposals at the annual conference. Resolutions are first vetted through the Technical Committee or the Development Committee, and then submitted to a majority vote in the Presidents' Committee, which is comprised of all the presidents of regular and associate member agencies. Resolutions are only adopted if a majority of regular members approve at the annual conference (Steil, 1994: 199; Coleman and Porter, 1994: 200).

On prudential regulatory issues such as capital and disclosure, IOSCO has adopted the looser UK standards than those in the U.S. for capital (netting of positions is allowed and disclosure requirements are lower than in the U.S. market; Steil 1994: 203 ff). It would be easy to infer from this that the loose organization of IOSCO, compared to the smaller and more homogeneous Basel Committee, produces different levels of coordination. Such a diffuse and weakly empowered body such as IOSCO has more difficulty preventing a regulatory "race to the bottom." But, of course, no international organization has the independent power to enforce its will upon sovereign states.

Such an interpretation would be mistaken. Securities firms, unless they are part of a universal bank, are not depository institutions and the asymmetry of information is less of a problem because failure need not lead to runs (Kapstein, 1994: 151). In other words, banks are inherently more costly producers of securities services. Having weaker prudential rules for securities firms is less dangerous to the public at large (Steil 1994: 206; Bronfman, Lehn, and Schwartz 1994: 59). Capital standards and disclosure rules, beyond a certain level, discourage customers without increasing the soundness of the financial system as a whole.

Why, then, does the U.S. have prudential rules in the securities market that are "too high" by global standards? The answer, we venture, has to do with the higher proportion of small, less informed and therefore potentially vulnerable investors in the U.S. market compared to most securities markets elsewhere. The U.S. government made the choice to add an extra layer of regulatory safety at the expense of some large denomination business that relocates to wholesale markets such as London's. Other countries will have to make their own policy trade-offs if more small investors become players, but so far the London model sets the global standard.

Another implication of this prudential difference between depository institutions and securities firms is, as Verdier perceived some time ago, that the apparent move towards the universal banking is deceptive (1998: 29). It is true that the U.S. and Japan have finally gotten rid of the legal boundary between banks and securities firms. This is driven by the general trend towards consolidation in the banking industry and by banks' desire to get involved in the securities business as it begins to overshadow more traditional lending worldwide. German universal banks have found that their customers are concerned about possible conflicts of interest when banks handle securities transactions. This has led German banks to handle more transactions out of securities subsidiaries and to ensure strict boundaries between banking and securities activities within the conglomerate.

4.4 EU Directives:

How can we be sure that policy choices emanating from domestic politics, rather than the organizational features of the Basel Committee and IOSCO, are responsible for the different levels of prudential regulation in the banking and securities industries? There is another piece of corroborating evidence pointing in this direction. Financial and investment directives adopted by the EU look virtually identical to the recommendations made by the Basel Committee and IOSCO. Contrary to arguments about the "Anglo-American conspiracy" in global finance, banking rules are converging on the U.S. depositor-based model and securities rules take after the more flexible wholesale securities market in the UK. Even that oversimplifies, because the idea of risk-based capital actually came from European regulation and was not adopted by the U.S. until the 1980s. The similarity is that both are broadly prudential, rather than profit padding, making them compatible with the increasing competitiveness in financial markets as big investors and big borrowers shop across borders.

Another bit of evidence for the domestic purposes of prudential regulation is the widespread adoption, in the past few years, of deposit insurance. In profit padding schemes, where banks typically do not fail, deposit insurance is redundant. No need to saddle banks with insurance premiums if the government guarantees bank solvency anyway. With the increasing competition in banking services, however, the EU and more recently, Japan, have shored up their deposit insurance schemes (Fratianni, 1996; Nihon Keizai Shimbun, various issues). Should a bank become insolvent and be allowed to fail, deposit insurance prevents depositors from panicking and precipitating a bank run.

5 Checking the Argument

Global integration of financial markets pushes governments to abandon banking cartels in favor of prudential rules. But we need to understand the incentives that national politicians face to explain the remaining variation across countries in how banks are regulated. This is particularly true for the part of the banking system that caters to sectors of the economy without access to international financial markets. In this section we offer some preliminary data to back up our claims about the importance of domestic political institutions.

Politicians in different institutional environments should have systematically different incentives for how competitive financial markets should be domestically, and for how thoroughly to enforce prudential regulation in the wake of that competition. Our current data only allow us to test the first proposition: that, all else equal, centripetal electoral rules give politicians an incentive to promote a more competitive financial market, even at the expense of bank profits. For now, we settle for descriptive comparisons for differences in prudential regulation.

5.1 Political Institutions and Competition

Our first hypothesis is that, as we argued in section 3.1, centripetal systems such as single member districts (SMD) force politicians to appeal to broad swaths of the voting public, such as consumers. By contrast, centrifugal systems, such as Japan under SNTV and Germany with its variant of PR, allow politicians to win representation by appealing to groups that do not themselves make up majorities.

To operationalize the electoral system variable, we use two related models. First we use a dichotomous variable drawn from Cox (1990) that takes on the value 0 if an electoral system produces centrifugal effects and 1 if an electoral system produces centripetal effects. Lijphart's effective threshold (1994) is a continuous variable that measures the percentage of the vote necessary to win legislative representation.

To measure banking competition, we look at interest rate differentials between standard deposit rates and consumer lending rates (IMF Statistical Yearbook 1999). This differential represents, in broad terms, bank profits. We expect that countries with higher effective thresholds have smaller interest rate differentials because these electoral systems force politicians to cater to consumers. Table 1 makes this point. The UK and US, both using single-member district electoral systems that produce centripetal incentives, have lower spreads that do Japan and Germany.

Table 1

	UK	**US**	**Japan**	**Germany**
Interest Rate Differential	**1.68**	**2.29**	**2.99**	**5.64**

To see how this proposition fares in a larger sample, we ran a regression of effective threshold on interest rate differentials in 23 countries from 1980 to 1998. Although this is a crude, uncontrolled regression, it offer some preliminary evidence of the impact of electoral competition on interest rate differences. It suggests that a change from a pure SMD system with effective threshold of 35, to a pure PR system with an effective threshold of say 1 (for a 100 member legislature) corresponds to a change of 2 interest rate points. In other words, other things equal, a pure PR system should have a interest rate difference larger by 2% than a pure SMD country.

Table 2: OLS estimates of the effects of electoral institutions on interest rate differentials for industrial democracies, 1978-1998.

Regression Estimates and Standard Errors

	1	*2*	*3*	*4*
Intercept	5.12*	5.36*	4.72*	4.95*
	(0.16)	(0.16)	(0.12)	(0.12)
Effective Threshold	-0.060*	-0.066*		
	(0.008)	(0.008)		
Centrifugal vs. Centripetal			-1.82*	-2.04*
			(0.24)	(0.23)
Switzerland		-3.30*		-3.45*
dummy		(0.48)		(0.48)
N	381	381	381	381
Adj. R^2	0.12	0.22	.13	0.23

*p<.01

5.2 Political Institutions and Prudential Regulation

We also expect centripetal systems to enforce stronger prudential rules, since these pay for depositor safety at the expense of banks. The first measure of this is regulatory staff. This is a crude measure, but many countries do not list personnel by financial sector (eg. banking, securities, and insurance). Here, controlling for the number of institutions the regulators must monitor the data come out in the way we would expect.

Table 3

	UK	**US**	**Japan**	**Germany**
Regulatory Staff	**1800**	**11772**	**655**	**1080**
Ratio (staff per institution)	**.89**	**1.13**	**.78 (in early 1990s)*[7]**	**0.28**

Second, we have found variation in one aspect of deposit insurance systems that speaks to the breadth of prudential regulation: The deposit insurance system (DIS) premium charged to banks. We should find that this is larger in countries that are more likely to favor consumer interests (or where politicians are more wary of voter outrage should a government bailout of insolvent financial institutions become necessary). In fact, DIS premia are quite low in Japan and Germany compared to the US. The UK represents a different regulatory choice, where the insurance premium is callable by financial regulators according to need. The UK system creates incentives for cross

[7] Japan's regulatory staff has been gradually increasing even as the number of regulated financial institutions has declined during the 1990s. By 1999 Japan's ratio of staff to institution had risen to 1.32.

monitoring because banks will have an interest in keeping others from taking on risk that may end up costing them all.

Another form of prudential regulation that we do not yet have data on but that we plan to investigate is disclosure requirements. Countries with more stringent requirements should be those most interested in protecting ordinary consumers. The conventional wisdom is that disclosure is highest in the US, followed by the UK with Germany and Japan (until recently) trailing significantly.

5.3 Trends Toward Greater Prudential Regulation

We do not yet have a systematic dependent variable to demonstrate the trend toward greater prudential regulation over time, but we can offer some suggestive descriptive statistics. Japan has strengthened three types of prudential regulation in the 1990s. First, it has hired significantly more financial regulators to monitor banks. Second, disclosure rules and reporting requirements have made the financial sector increasingly transparent. Third, the deposit insurance premium is being raised to provide for a larger safety net for future insolvencies.

All of these statistics supplement our argument that domestic political institutions explain a significant share of the variation in financial regulatory policy among industrial democracies. In the following section, we pick up a magnifying glass to show the links in the causal chain of our argument in the case of a country that had a long ways to go in adopting a prudential model: Japan.

5.4 Microfoundations: An Illustrative Case

We have shown that rules in financial markets around the world have moved towards a prudential model. The reason, we argued, was that mobile capital has made the old profit padding ways of ensuring bank stability no longer tenable. We need to demonstrate that governments recognized their choices: keeping the old profit padding rules requires closing borders to financial flows over the objections of big corporations; allowing corporations financial freedom means adopting prudential regulations in banking. At the same time, governments have crafted their regulatory responses with due consideration of powerful domestic interests.

International financial competition first caused trouble for Japanese banks when the Euromarket drew Japanese corporations out of Japan in droves. Such was the political power of Japan's corporate world that the government did not even try to stop this trend. Instead, Japanese banks followed their erstwhile customers abroad, and soon became some of the fiercest competitors in the market. Japanese banks were, essentially, replacing lucrative domestic business with razor-thin profit margins abroad. As profit margins in corporate finance shrank, Japanese banks were not required by domestic law to increase capital substantially in proportion to loans. Japanese banks remained afloat courtesy of the still-protected retail sector back home and the Ministry of Finance's implicit guarantee that no Japanese bank would fail.

The MOF's failure to implement prudential rules in Japan was not for lack of trying. Repeatedly in the postwar period, the MOF had attempted to strengthen the legal basis of its regulatory oversight but in every instance was rebuffed by the politicians who pass-or don't pass-the laws that the bureaucrats draft. In exchange for hefty campaign contributions from banks, the ruling Liberal Democratic Party ensured that the MOF's role in the banking industry was more of a mother hen than of a stern disciplinarian.

Profit padding at home gives banks the ability to subsidize operations abroad. The 1988 Basel Accord was, as we know, aimed in part at reducing Japanese banks' perceived regulatory advantages. But the compromise hammered out was not entirely onerous to Japan. First, it allowed for dual regulatory systems whereby domestic banks could abide by a reduced 4% capital requirement and only internationally active banks would be subject to the 8% requirement. Second, recall that the effect of the 8% capital requirement was softened by allowing 45% of unrealized gains from equity holdings to be counted as capital.[8] In the context of the asset bubble, most Japanese banks met these standards handily. Because Japanese government officials were unaware that they were riding on a bubble rather than genuine prosperity, they maintained prudential standards that ultimately proved inadequate.

It was not until Japan's asset bubble burst in 1990 and 1991 that Japanese banks felt the pinch of the capital requirements. The decline in equity prices and the subsequent collapse of land prices forced many financial institutions to the brink of insolvency. We now turn to the government's response to the crisis, and reasons why Japan decided to remain in the Basel system despite the costs involved.

The initial response of the MOF was to pull the convoy system together and force the strongest banks to absorb the weakest. This was not a new idea. In postwar period, banks fallen on hard times had been quietly merged into another bank. But during three decades of high growth, relatively few banks failed, regardless of how poorly they were managed. This time around, however, MOF's merger plans hit a snag: the stronger banks balked. Acquiescing to the plan would have pushed even the healthiest of banks into the red on their capital requirements and forced them to abandon their international activities. The financial crisis divided banks between strong and weak to a degree they had never been before. The MOF abandoned forced consolidation, and resorted to its second option: helping all banks muddle through. One former MOF official claimed that he was "shocked, shocked, that banks should have been so selfish and uncooperative in the face of a national crisis."[9] The convoy system, it seems, required good times to stay afloat.

The MOF softened the effect of the 8% rule somewhat by classifying nonperforming loans in a more favorable category. But accounting tricks have limited value in an era where rating agencies look into the banks' books to determine the price of bank capital on international markets. Partly for this reason, and to reassure international investors and borrowers, Japan decided in 1999 to adopt international accounting standards by 2002.

Meanwhile, electoral reform in 1994 broke an institutional roadblock to financial reform. In the place of multimember districts in which LDP politicians competed with one another for corporate patronage, new single member districts and PR lists forced politicians to go after average voters instead. Voters had been an afterthought in the convoy rules; indeed, they had paid for financial stability with high costs of financial

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[8] The Japanese had wanted 75% of unrealized capital gains to count as capital, but 45% was the "bottom line" that allowed Japanese banks to clear the hurdle.
[9] Interview, July 2000.

services. By virtue of the "Big Bang" legislation passed in 1996, banks and securities firms would increasingly have to pay for financial stability themselves, by the prudent management of risk that new rules required. To back up the promise, bank regulatory authority has been transferred from the MOF to a new watchdog agency, the Financial Services Authority.[10]

Politicians are masters of compromise, and even under the new electoral rules they are searching for ways to protect a favored interest group, small and medium sized enterprises. These constitute the vast majority of businesses in Japan, in terms of numbers and employment. Over the objections of MOF bureaucrats and some politicians, the government has for the time being decided to allow small banks to operate at a lower capital standard of 4%.

This constitutes a remaining chunk of profit padding for the sake of small businesses that do not have the economic scale or promise to raise funds in international wholesale markets. In exchange for this lower capital requirement, the "domestic banks" are required to show that a substantial portion of their loans are to local business enterprises (Kinyu Janaru, September 1999, pp. 101-115; December 1999, pp 113-117). It remains to be seen, however, what will happen to inefficient banks when they are faced with growing competition from the efficient banking sector. Voters are now empowered, as they were not under the old electoral rules, to punish politicians who use public money to rescue unworthy causes.[11]

An indication that inefficient banks are operating on borrowed time came in February 2000 when the then head of the Financial Reconstruction Commission was sacked for suggesting that he, or other politicians, could intervene on behalf of weak banks in the event of tough audits from bank supervisors.[12] Weeks later, a group of politicians were rebuffed in their attempt to exempt small banks from mandatory deposit insurance. Had they succeeded, financial authorities would have been obliged to ensure through other means, such as profit padding and regulatory forbearance, that small banks did not fail. As it happened, politicians read the stern warnings in the opinion polls and voted for a year's delay in deposit insurance instead.[13]

6. Conclusion

This paper has argued that governments are shifting in droves from padding banks' profits towards a prudential system of financial regulation. The reason, we suggested, lies in calculations that politicians make the world over to stay in office. Few

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[10] Hiwatari. The agency was originally named the Financial Supervisory Agency, but renamed the Financial Services Agency in July 2000. The similarity to the UK's Financial Services Authority is no mistake. The officials in Japan's FSA want to make it clear that their mandate is not to prop up decaying banks but to ensure the safety and quality of financial services.

[11] See, for example, the LDP's hasty retreat from bailing out Sogo Department Store. Asahi Shimbun, various issues in July 2000.

[12] The Financial Resonstruction Commision was created to oversee Japan's banking system crisis and assist with disposal of nonpeforming loans.

[13] Jinno Naohiko, "Sefuti netto naki kisei kanwa no kiketsu," *Keizai Seminaa*, December 1999: 30-33; Hayashi Hiromi, "Kojin no kinyu shisan sentaku kodo ne nonkakuteki henka," *Kinyu Zaisei Jijo*, November 29, 1999: 12-15. Asahi Shimbun and Nihon Keizai Shimbun, various issues, December 1999-March 2000.

governments can afford to prevent domestic firms from accessing funds on world markets. But nor do they want to court disaster as the decay of protective measures leaves the banking system exposed to global competition. As a result, governments are requiring banks to hold more equity capital, to manage risk better, and to disclose their books to closer market scrutiny.

Our argument stands in contrast to two others. First, there is the group of scholars, mostly political scientists, that feared that international competition in banking would produce a regulatory "race to the bottom" as governments attempted to lure back lost business with ever more lax rules of conduct and oversight. On the basis of that fear, some international relations scholars have urged, and hoped for, the capacity of international institutions to harmonize banking rules somewhere before hitting bottom. In our view, however, international institutions may help countries choose the precise nature of those rules, but those institutions cannot force countries to abide by such regulations.

A second group of scholars, primarily economists, warns against premature selection of an equilibrium set of rules. Competition among national regulators is more effective than international coordination among regulators because, in the words of Edward Kane (1987: 121-122), "[o]verlapping jurisdictions lead competing regulators to develop a series of alternative patterns of coping with common problems that are routinely tested against each other in the crucible of experience. This allows regulatory problems to be resolved without betting all of society's chips on the problem-solving ability of any particular set of regulators."[14] We believe that this fear, too, is unwarranted under current conditions of voluntary compliance with Basel and IOSCO rules.

We have talked principally about the politics of mobile capital. Immobile capital—retail banking and small business financing—is likely to remain distinct across countries for some time to come. Differences may diminish in the European Union, particularly under monetary union, where banks have "passports" and can operate in any country under home country rules. But in Germany, laender governments still subsidize laender banks for the benefit of small and medium sized borrowers.[15] In the non-EU world, small banks are even more sheltered from the storms at the international wholesale level. In Japan, where only internationally active banks have to meet the 8% capital adequacy rules, small banks have for the time being retained some padding in their profits.[16] The question one needs to answer is, how much profit padding will make up for the growing efficiency of the competitive sector? The time may come when small business borrowers will choose more efficient banks on their own accord, forcing industry consolidation that small banks for the time being resist. Political choices, not unaided markets, lie at the heart of this logic. Customers with options make protection too costly, politically.

This brings us tantalizing close to an important debate in political science: are economies around the world converging on the Anglo-American model of competitive markets? A thorough discussion of this issue lies beyond the scope of this paper. But we

[14] See also Thomas Oatley, 2000.
[15] A case against the laender bank subsidies, brought by none other than German commercial banks, is pending in the European Court of Justice.
[16] In the U.S., by contrast, small banks are required to sock away more capital than money center banks because their loan portfolios are less diversified and therefore more vulnerable to ill economic winds.

do not want to convey the impression that competition in financial services is making a mockery of domestic politics by increasing the political costs of a growing number of policy options.

Governments still have a wide range of levers on social and economic policy, globalization notwithstanding. The encroachment of market competition does, however put many of these levers to a test: how much do they contribute to the public good, and does their use justify their cost?[17] This is a fundamentally political question. Banking was never, in any case, a particularly effective way for government to manipulate the economy, if Japan and Germany are any indication. Now that profit padding is harder than ever to justify, bankers will have to work hard to earn a living, just like everyone else.

[17] The same is true for issues such as corporate governance, except that here investors rather than voters will be making the decisions. Are governance structures designed to make capital more patient worth the cost in short term efficiency? The jury is still out. (Luetz 2000a; Schaede 1995: 93-119; Loewendahl 1999: 100).

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