BOOK REVIEWS

Financial Services, Globalization and Domestic Policy Change
William D. Coleman
St. Martin's Press, New York, 1996.

Financial markets are going global. Policy makers are struggling to adjust. This book, by a Canadian political scientist, exams the policy response in five countries, the U.S., Canada, the UK, France, and Germany. As one might expect from a political scientist the emphasis is on how countries reach their decision on how to respond as much as on how countries actually responded.

The emphasis is on two industries, loan making and security trading, which at the start of the period discussed, the 1960's were generally viewed as separate industries, with separate firms in each (except in Germany). In many countries, the business of making loans was divided among different types of firms, with firms called banks specializing in loans to business firms, and other firms (saving and loans, building societies) specializing in residential lending, and a variety of other intermediaries meeting the needs of the lower income populations, the rural population, or small businesses. In most countries there was a breakdown in the barriers between these separate segments, and a move towards permitting banking firms to engage in any type of financing, including selling securities. This is referred to as universal banking. Much of this movement was driven by the concern that if domestic firms did not expand and internationalize, some of the business would be lost to more flexible foreign firms.

In security markets, the pressure was to lower the prices to users of the services and make the services more efficient. While in the U.S., the pressure for this seems to have been directed towards benefiting the consumers of financial services (here especially the institutional investors), in other countries the move seems to have been driven by a fear that the business would go abroad unless the domestic markets were highly efficient and provided services at a low price.

While the focus of the book is on the process by which change occurs, it may be most interesting for the readers of this journal to point out how large the changes are that various countries have undergone. For instance, France started the period in the sixties with a highly fragmented system with commercial banks, merchant banks, savings banks, and financial cooperative all operating under different rules, with special institutions handling lending to agriculture, to artisans, and to local governments. Only 15% of the financial needs of the economy came through security markets. The government owned the major banks and in addition had a highly intricate system of credit controls and allocation, with 70 different interest rate regimes covering 44% of lending. A traditional career path had top graduates from the École Nationale de Administration move to the Grand Corps of the Inspection general des finances and from there to the Ministry of Finance. After a rapid rise through the ranks they were placed as senior executives in the nationalized banks. The whole system gave the government considerable power over how credit was allocated in the economy. It also permitted the control of the volume of credit by direct means, rather than through indirect means used elsewhere.

There was a monopoly on negotiating securities transactions held by stock exchange brokers (agents de change) with fixed commissions and low capitalizations. The individuals recognized as security brokers had their status changed to companies. They were permitted to expand into managing portfolios and to raise capital by selling stock to other financial firms. By the end of 1990, 80% of the firms had been purchased by banks, while insurance companies took over others. Few remained independent. France moved much more in the direction of the universal banking model in which banks participated in all aspects of the financing process, including selling securities. In 1984 a new law put under one legal framework the various types of deposit taking.

In contrast, Germany begin the period much closer to the universal bank model, where banks participated in both the credit and the securities business. A Commission considered carefully the abandonment of the German system of universal banking, but the idea was rejected. Indeed, the European Community endorse the universal banking idea when its Second Credit Directive permitted banks to engage in security dealing, portfolio management, and other investment services. The German banks position was further strengthened when the community decided to give banks access to the stock exchanges in all member countries.

Bigger changes were required in securities. Under the German

Federal system, the Landes had regulated the security markets. They were reluctant to do anything to handicap their local exchanges, although if Germany was to compete with London and Paris for international business it needed to concentrate its business in its largest exchange, Frankfurt. Inspired by international competition, a series of measures were undertaken to promote the Frankfurt market. In 1989 a revised stock exchange law opened the way for a fully computerized exchange and for a futures and options exchange. In 1990, the Federal government passed a law which removed the stock exchange turnover tax and broadened the categories of securities allowed for inclusion in investment funds. The Bundesbank finally agreed to the issuance of money market securities, and a corporate commercial paper market begin to emerge. Five regional security deposit banks were amalgamated into one, which gave Germany the fastest settlement system in the OECD countries. To further centralize things, the ownership of the Frankfurt exchange (along with that of the central security deposit bank) was vested in a new countrywide company which was 80% held by the banking industry, 10% by the Lander, and 10% by the security firms. To give the Frankfurt exchange creditability, a new central federal regulatory body was set up to deal with such things as insider trading.

In the sixties, London had a very informal regulatory system in which the Bank of England exercised informal supervision over the small number a major banks. The system worked as well as it did because the bank leadership and the Bank of England leadership had similar backgrounds. This informal regulatory system attracted business from the rest of the world, including the U.S., who found their costs were lower. But yet this internationalization contained the seeds of its own destruction, since those attracted by less formal regulation were not particularly concerned about the norms of "gentlemanly" behavior.

At the start of this period the commercial banking industry had little interest in the mortgage markets and the financing of British housing was handled primarily by building societies, which were limited to this function and raised their funds from members. A new Building Societies Act in 1986 left the societies focused on housing but gave the Building Societies permission to raise 40% of their funds from non-retail sources, including the money market. They were also allowed to diversify their lending to a certain degree. Provision was also made for Building Societies that wanted more freedom to convert to banks, and several of the largest did. Meanwhile, market deregulation permitted the banks to move into the traditional territory of the building societies. They captured 30% of the market by 1989. Interestingly, there is little discussion of the British Big Bang (in which the British securities market was reorganized), but some of the changing structure of securities regulation.

In Canada, the financial services industry had traditionally been built around four "pillars," banking, trusts and estates management, insurance, and security dealing. Each was controlled by Canadian firms, even though much of other Canadian industries was American controlled. Again competitive pressures from globalization led to interest in desegmentation, and making Canadian firms large enough to be internationally competitive. The Federal nature of Canada complicated desegmentation, and the required harmonization of the regulations for different types of firms. The provinces had traditionally regulated businesses, including most financial ones, with Quebec particularly jealous of its prerogatives. However, the Canadian constitution assigned "banking, the incorporation of banks, and the issuance of paper money" to the Federal government. This led to there being a category of Federally chartered banks. Whatever they were allowed to do was defined as banking.

The core function of the trust companies, the management of trusts and estates, caused them to be originally provincially chartered. However, by receiving money "in trust", paying interest, and guaranteeing the return of the money, they became takers of time deposits. Since they could invest the money they held in trust, they were also in the business of lending money. These companies could get charters from the Federal government for these functions. Provincially regulated financial cooperatives also emerged, and engaged in deposit taking and lending. The result was a group of near banks that were banks in all but name.

In the 1980 Bank Act, the chartered banks' monopoly of the payments system was eliminated by setting up a new payments system, the Canadian Payments system. Federally chartered banks had to join, and other deposit takers could join. In practice the largest non-bank ones did. The chartered banks were allowed to become full competitors with the trust companies, and cooperatives in the residential mortgage field. In practice, trust companies came to be frequently owned by banks. By the mid-nineties, chartered banks could operate in all financial areas either directly or through subsidiaries, with financial cooperatives in Quebec and British Columbia having similar commercial freedom. Trust companies were freer, but still subject to some restrictions.

Canadian chartered banks had traditionally traded in fixed income securities and money market instruments, while separate security firms (provincially regulated) underwrote corporate debt and equity, and did equity trading, and investment management and counseling. Foreign firms were not allowed to own these security firms.

This division was threatened when the Bank of Nova Scotia exploited a loophole to register a securities subsidiary in Quebec. Ontario, afraid other banks would open security subsidiaries in Quebec (taking business away from their firms) announced its intention to permit banks and trust companies to own securities subsidiaries and to open up ownership of securities houses to foreigners. About this time the Federal government expressed its desire that banks be able to enter the securities business. After discussion, the banks were allowed to set up subsidiaries under provincial regulation for the provincially regulated securities businesses (while continuing their traditional trading of debt securities under Federal oversight). The result was a Canadian "Little Bang" on June 30, 1987.

Thus there was a substantial merging of the securities and banking business. All of the "Big Six" banking firms went took over a securities firm or started their own, and by 1990 over 80% of the securities business was under the control of commercial banks. Following Federal legislation, the banks moved into the trust and estates area by purchasing companies or setting up subsidiaries. By 1994, three of the four largest trust companies were bank owned.

The result of this desegmentation of the Canadian financial services industry was to increase the size of the Canadian banks, and to position them to compete better on the international scene, especially with the American banks. Canada has entered into a free trade agreement with the U.S. and Mexico which had provisions covering financial services, permitting U. S. banks to compete in Canada.

The United States started this period with the most fragmented system of any of these nations. The McFadden Act prohibited new branching across state lines, and many states prohibited banks from any branching. One Federal regulation limited thrifts to making loans within 50 miles of their branches. Commercial banks were prohibited from underwriting commercial debt and equity securities.

This system begin to unravel in the sixties. Vietnam era inflation raised interest rates. Commercial borrowers discovered the small commercial paper market. The commercial banks responded by introducing their own money market instruments, negotiable certificates of deposit. The higher market interest rates created problems since thrifts and banks had built their business on taking in deposits at low rates, and lending them at higher rates. Money market mutual funds were invented, and thrifts begin to lose deposits. If the thrifts responded by purchasing funds on the money markets, they could easily be paying more for the deposits than they were earning on the loans. This produced the U.S. saving and loan crisis, and a massive (150 billion dollar) Federal bailout.

Market desegmentation in the U.S. proceeded in stages. The Depository Institution Deregulation and Monetary Control Act of 1980 loosened interest rate ceilings, increased the flexibility of savings and loans to make mortgage loans, and permitted thrifts to hold commercial paper and to expand into services like personal loans, credit cards, etc. The Federal Reserve Board was also given power to set reserve requirements for all transactions accounts of depository institutions.

The last of a series of deregulatory Acts in 1994 permitted bank holding companies to expand into any state. However, by then most states had already permitted branching through their own laws.

The above is just a sketch of the changes in financial services that occurred in different countries. This review has focused on the actual changes, but since this is a book by a political scientist, much of the discussion concerns the mechanism by which these changes took place. Particular emphasis is placed on the nature of the policy communities, i.e. who the players were and which organizations (commercial and governmental) and types of firms were involved in the discussions. The most important finding is that consumer interests appear to be under represented in a process that is dominated by the financial institutions themselves and a few governmental bodies.

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Markets and People: The Czech Reform Experience in a Comparative Perspective
Jiri Vecernik
Avebury, Aldershot 1996

Institutional Design in Post-Communist Societies: Rebuilding the Ship at Sea
Jon Elster, Claus Offe, Ulrich K. Preuss, Frank Boenker, Ulrike Goetting & Friedbert W. Rueb
Cambridge University Press, Cambridge 1998

The collapse of the Soviet Empire ruined the careers of quite a number of academics. Some Sovietologists managed to adapt their skills and become experts on Russian affairs. But Kremlinologists, academic experts on deducing the Soviet power hierarchy from the position of leaders on Lenin's tomb during May Day celebrations, disappeared. Still, new academic specializations emerged after 1989. Chief among them is "Transition Studies," the study of the transformation of postcommunist countries from political totalitarianism and command economy to free market democracy. Many transitologists are economists.

Former Czech Prime Minister Vaćlav Klaus used to compare the reformers and entrepreneurs in the postcommunist world to the first white settlers of America. "The settlers came first and the law second." But when the first white men came to America they faced an embarrassing surprise: though they assumed that they were going to the eastern part of India, they discovered they were actually in an unknown new continent. When economists came to transform the command economies of postcommunist countries they also had to face an embarrassing surprise: the assumptions of classical economics fail in the postcommunist context because economic transitions take place within structured societies.

People do not behave in the real world as abstract economic agents of economic theory who attempt just to maximize their profit in a market. Economic behavior is affected by the social contexts in which economic agents are embedded, by their affiliations with a social network, for example, their membership in the old nomenklature. The existence, integrity and independence of institutions such as the police and the judiciary determine whether the rule of law and property rights that are the foundations of any liberal economic system will be enforced. For example, if there are no regulations to prevent embezzlement and theft by