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**Finance and the Macro-economy:
The Politics of Regulatory Reform in Europe**

by

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Abstract

This paper analyzes major changes in the regulation of the financial sector in Europe over the last three decades. Focusing on the pattern of change across five countries (Britain, France, Germany, Italy and Spain), the paper identifies two major periods of regulatory change: first, the shift away from postwar patterns of credit regulation in the 1970s and 1980s, and second, the intensification of state supervisory powers and the introduction of new regulatory structures from the 1990s to the present. In both cases, the authors point to the way in which different models of financial sector regulation affect the political consequences of macro-economic policy for political elites as an explanation for choices that governments have made in the regulatory arena. More specifically, while regulatory change in the first period may be largely explained by the way in which different postwar models of credit regulation impinged upon a government's political ability to impose disinflation, choices in favor of different regulatory structures in the second period (single regulator in Britain and Germany versus multiple regulators in the other countries) can be related to differences in the area of pension reform. By focusing on the political implications that different modes of financial regulation can have for elected officials in the context of different macro-economic scenarios, the authors offer an explanation of regulatory change that differs from accounts which emphasize the primacy of financial market forces in driving such change.

The liberalization of national financial systems has been one of the major regulatory developments of the last three decades across both advanced industrialized and developing countries. This regulatory trend is of the utmost importance as financial systems mediate the allocation of savings and capital in an economy and hence are central to the economic trajectory of nation-states. The question remains, however, as to how and why financial liberalization and regulatory reform take place. While liberalization and regulatory reform are almost always couched in the language of market efficiency, purported economic benefits do not of themselves provide an adequate explanation for regulatory change. For such change to occur, there must be actors with specific objectives and with the political capacity to bring about change. Understanding the motivations that guide such actors is critical in understanding the shape that regulatory reform takes. Yet, on this question of the “politics” of regulatory reform the political economy literature has offered few consistent answers. While most authors emphasize the driving role of world financial markets in forcing recalcitrant governments to abandon traditional modes of financial market regulation, others emphasize the leading role of state officials in advancing national objectives and the persistent impact of institutional differences in the structure of national financial systems.

In this article, we seek to further our understanding of regulatory change by highlighting the ways in which the regulation of national financial systems is linked to features of the domestic political economy, and specifically to the calculations of elected officials with respect to the politics of macro-economic policies. To understand the complexity of recent regulatory trends across countries we must move beyond the question of whether reform is state- or market-led, and whether it is institutionally constrained. We must look at the manner in which the regulation of finance institutions and flows affects the political cost of different forms of macro-economic adjustment and at how different choices in the area of macro-economic policy affect the political salience of financial market regulation.

The empirical basis for our argument is provided by a comparison of the patterns of reform over the last three decades across five European states (Britain, France, Germany, Spain, and Italy). These cases represent the largest economies in the EU as well as a range of different regulatory starting points. The course of regulatory reform in these five cases has been marked by cross-national similarities and differences that vary from one period (the 1970s and 1980s) to another (the 1990s and on) and that cannot simply be attributed to international market pressures or varying institutional starting points. Indeed, the course of reforms takes turns that seem paradoxical from either a market-driven or a standard institutionalist perspective. One such aspect is the relative timing of reform efforts. The first countries to undertake major overhauls of their postwar modes of financial sector regulation (in the 1970s and mid-1980s) were Britain (with the most market-based financial system) and France and Spain (the most interventionist), whereas in Germany and Italy (with a private-bank-organized and a state-controlled financial system, respectively) there were no major overhauls until the 1990s. On the other hand, Britain and Germany (the cases commonly viewed as starting with the most market-based and the most organized financial systems respectively) have seen the most dramatic change in regulatory structures in recent years with the consolidation of autonomous regulatory agencies into single regulatory bodies that are accountable to the political executive, whereas France, Spain, and Italy have retained multiple, autonomous regulators with differentiated functions and an important regulatory role for their central banks.

We are able to relate many of the differences and similarities in this complex cross-national pattern of regulatory reform to three variables: 1) macro-economic policy choices involving significant distributive consequences and hence potential political costs for elected authorities, 2) the way in which particular modes of financial system regulation affect the transparency of those macro-economic choices (and hence the ability of voters to establish political accountability) and 3) the way in which macro-economic choices by governments, in turn, affect the political salience of financial system regulation. More specifically, we find that early moves to abandon established modes of financial regulation in the 1970s and 1980s occurred in those countries (Britain, France, and Spain) where political elites had opted in favor of cheap-credit driven growth strategies in the early postwar period. They did not occur, in spite of rising international financial integration, where governments had opted for export-led growth models premised on price stability in that period (Italy and Germany). On the other hand, the move to create powerful, politically accountable single regulators has occurred where, due to fiscal policy considerations, governments have made a decisive political bet on promoting private pensions (Britain and recently Germany) as part of welfare reform. They have not occurred in the other three cases, where private pensions have not played a prominent role in welfare reform, and where central banks were well positioned to retain a regulatory role. All this leads us to conclude that the political calculations of elected state elites regarding the effects of macroeconomic choices play a more important role in explaining the course of financial regulation than is commonly recognized.

The cross-national variation we observe in the timing of reforms and in their institutional outcomes points to the way in which financial regulation is linked to broader questions of political transparency and accountability in market economies. We suggest that, because of the financial system's role in mediating the allocation of savings to all other sectors of the economy and its unique role in mediating key government policies, the politics of regulatory reform of the sector cannot be captured from a strictly sectoral perspective such as might be appropriate in analyzing trade policies or even the regulation of public utilities. The regulation of financial institutions is subject to particular regulatory problems that are inescapably linked to the character of macroeconomic policy. The sector acts as the principal conduit of monetary policy, so that the consequences of that policy are experienced by citizens and businesses through the actions of financial institutions (in particular banks). Different models of financial market regulation render monetary policy decisions - and the manner in which they affect different segments of the population - more or less politically transparent, increasing or reducing the political costs of such decisions. On the other hand, the sector's role in allocating the savings of individuals renders it the principal alternative to public provision of income to non-working citizens (in particular pensioners). This links financial sector regulation to questions of political accountability for welfare provision and the regulation of risk in market societies. Thus, for example, decisions in the area of fiscal policy, in particular efforts to shift the burden of old-age pensions from state pension systems to the private sphere, tend to raise the political salience of financial sector crises and with it, that of the supervision of the financial system.

While we propose a view that pays greater attention to the relationship that financial regulation holds to the politics of macro-economic policy in order to explain differences in the course of regulatory reform, we also note important general trends in this relationship that lead us to distinguish three main periods in the course of regulatory reforms: 1) an initial period lasting from the era of postwar reconstruction to the late 1960s, in which the internal and external

economic context of countries allowed for different choices in macro-economic strategies that, in turn, produced major differences in financial regulation; 2) a period lasting from the collapse of Bretton Woods through the 1980s, in which the principal challenge confronting governments was that of fighting inflation, leading some governments, but not all, to seek to alter their regulatory regimes, and 3) a period starting in the early 1990s when the problem of inflation had largely subsided and changes in the composition of domestic savings markets, resulting from pension reform and privatization, has created new incentives for political elites to intensify state supervision of the financial system.

The overarching point that we seek to illustrate is how important the politics of macro-economic policy has been in determining the regulation of finance. Our argument is one of path dependence, in the sense that early macro-economic policy choices in the postwar period led political authorities to opt for different regulatory regime for finance which, in turn, produced different incentives for regulatory reform in the second period. And fiscal policy changes in the 1980s and early 1990s produced new pressures for further regulatory reform in the 1990s. More specifically, we find that in countries where governments in the immediate postwar period opted for growth models based on cheap credit (as was the case in Britain, France, and Spain), postwar financial regulation took a shape that highlighted the distributive impact of economic adjustment measures once the cheap credit growth strategies had to be abandoned. In these countries, the turn to a less accommodating monetary policy following the oil shocks of the 1970s led, in fairly short order, to major regulatory changes, starting with the deregulation of credit followed by early initiatives to boost the role of capital markets. By contrast, in the two cases where political elites in the postwar period had opted for growth strategies that were premised on price stability (Germany and Italy), the frameworks of regulation created after the war were left largely unaltered until other pressures (most notably the creation of a single European market in financial services) took effect in the 1990s. We suggest that this is because financial sector regulation, though quite different in character in the two countries, nevertheless took a form that did not seem to politicize economic adjustment in the 1970s and 1980s. On the other hand, we also find that the second major change in financial regulation, namely, the decision by governments to intensify the supervisory role of the state over their financial systems in the 1990s, can be linked to prior fiscal policy choices, and in particular to efforts by governments to achieve fiscal consolidation via the privatization of state assets and of old age pensions, which have had the unintended effect of raising the question of political accountability for market failures and, with it, the salience of financial regulation.

In the following two sections we lay out the principal regulatory divides, between the first and second periods and between the second and third periods, and seek to explain the cross-national patterns that we see in each case. Lastly, we seek to explain differences in the way in which governments have sought to reorganize their regulatory institutions in the most recent period by looking at changes in the structure of domestic savings markets and at the way in which the role of central banks, which had developed as the default regulators of the financial system in previous periods, have been affected in the last round of regulatory change.

I. Postwar models of financial regulation and the first wave of regulatory reform

Two kinds of themes have dominated the study of financial systems by political economists over the last half century. In the 1970s and 1980s the primary focus was on the impact that

differences in national financial systems had for economic performance across the industrialized world. The work of Andrew Shonfield, John Zysman, Peter Hall, and David Soskice among others suggested that differences in national financial systems gave countries different comparative advantages and led them to pursue different postwar economic strategies. Such differences in financial systems continue to be highlighted in the contemporary literature on varieties of capitalism, which has tended to emphasize the persistence of institutional differences in financial systems and their impact on firm strategies (see chapters by Hanke and Vitols in Hall and Soskice 2001). Since the late 1980s, however, many authors have argued that growing integration of international financial markets would erode differences in financial systems as governments were forced to converge towards a liberal regulatory regime that was friendly towards holders of financial assets who now had greater exit options (see, for instance, Frieden and Rogowski, 1996). Regulatory reforms carried out under the banner of financial “liberalization” over the last two decades are often cited as evidence for the latter view, whereas persisting differences are cited by proponents of the former.

If we turn to the five economies under consideration, however, we find that neither the thesis of institutional persistence nor the thesis of market-driven convergence toward the Anglo-Saxon model advanced by the globalization school fit particularly well with the trends in financial regulation we observe across these countries. We find rather that the dynamics of financial regulation differed substantially between countries in ways not explained by institutional legacies per se or international market forces alone, and that the driving factors behind stability and change in financial institutions changed significantly from the 1970s to the 1990s.

In the two decades following the end of World War II, the regulation and characteristics of national financial markets took different forms across Western Europe. In spite of common challenges of postwar reconstruction and an international currency regime that allowed for intensified integration of product markets, national financial systems remained closed to the external world and political authorities chose to regulate their domestic systems in significantly different ways. The clearest difference involved the manner in which the financing of non-financial firms was addressed, including 1) the contrast between the British model of financial regulation based on the separation of commercial and merchant banks, in which corporate finance was left largely to capital market issuance organized by the latter, and the commercial bank-based systems of corporate finance in Continental Europe and 2) among the latter, the contrast between the German model, in which corporate finance was organized by private and local, semi-public, universal banks and the French model of selective credit regulation that allowed the state to direct the allocation of financial resources in the economy (see Zysman 1983 Hall 1986, Loriaux 1991). These differences in national regulatory regimes were seen to lie behind important differences in postwar economic strategies and outcomes including the French effort to shift resources from low productivity agriculture to high productivity industry, Germany’s capital and technology intensive strategy of export led growth, and Britain’s failure at industrial policy (Zysman 1983).

The two-way typology distinguishing between market- and bank-based systems on the one hand, and state interventionist versus non-interventionist models of corporate finance on the other, is often thought to capture the emergence of historical types that followed from a combination of the timing of industrialization and prior institutional legacies to produce distinct institutional logics in the course of development. One can cite here the arguments regard-

ing the arms length relationship between British industry and finance (linked by Gerschenkron to early industrialization), the role of universal banks in German industrial development (again linked by Gerschenkron to late industrialization), and the legacies of Colbertism in France emphasized by Andrew Shonfield and others. Yet as we move beyond the British, French and German cases we find that a purely institutional explanation for postwar regulatory modes does not seem to hold. Thus, in Spain, where the banking system that emerged at the turn of the century was characterized by private universal banks with heavy industrial stakes, political authorities under the Franco regime nonetheless imposed a regime of selective credit regulation linked to indicative planning that closely resembled that developed in France. And in Italy, where the state had largely nationalized the banking system in the 1920s, postwar governments never developed the systematic regulation of credit linked to indicative planning that we see in France and Spain. Instead, postwar Italian governments came to rely on their control of the *Istituto per la Ricostruzione Industriale* (IRI) banks to exercise direct political discretion in the allocation of credits, limited, however, to only a portion of the market (Perez 1998). On the other hand, in Britain, usually distinguished by the market-based character of its corporate finance system, the activities of the commercial banking system (clearing banks engaged in deposit taking and consumer lending) were subject to an extensive regime of state controls during the postwar period, including direct regulation of the Bank rate, direct quantitative controls of bank advances and credit flows (Cameron 2004).¹

The approaches taken by political authorities toward the allocation of the financial sector's resources thus involved different forms of state interventionism and of reliance on private actors that cannot be captured simply in a "state *versus* market" dichotomy. We find it more useful therefore to distinguish three types of credit regimes among our five countries: 1) a private bank organized system, with only a limited role for the state in the direction of credit (as in Germany); 2) a system of comprehensive credit and interest rate controls (either selective as in France and Spain, or more general as in Britain); and 3) a segmented system in which political authorities exercised control over a portion of the credit market through nationalized credit institutions, without imposing any comprehensive regulation of the credit market (the case in Italy). The key distinction that sets our analysis apart from the state versus market typology here is that between the latter two models. We refer to the first of these (Britain, France and Spain) as a "soft but comprehensive" form of interventionism, and the latter (Italy) a "hard but limited" form of state control over credit.

The postwar picture of divergence in regard to credit regulation just painted began to change in the early 1970s, when governments in three of our five cases (Britain, Spain and France) undertook major regulatory transformations. In Britain, direct credit controls were dismantled in 1971 in favor of "competition and credit controls" (the lifting of quantitative controls and the replacement of the regulated Bank Rate by a minimum lending rates and reserve ratios deposited with the Bank of England). This first attempt at liberalization failed when secondary banks used the opportunity to engage in a short-term borrowing and generated a lending boom, leading to the imposition of new direct controls via the requirement of supplementary special deposits by banks with the BoE (the so-called Corset). But it was followed by a second,

¹In this particular sense, the postwar British regime for the commercial banking sector came closer to the comprehensive regulation of credit markets that we see in France and Spain, than it does to the less comprehensively regulated credit regimes in Germany and Italy.

this time successful, liberalization of the credit market in 1980 (Cameron, 2004), and in 1986 by the reform of the securities markets – the so-called “Big Bang” – (see Moran 1991). In the case of Spain, the system of selective credit rediscounting was transformed into a system of compulsory credit coefficients in 1971 that were subsequently dismantled after the Spanish transition to democracy, bringing state-directed credit allocation to an end (Perez 1997). This was accompanied by a major reform of the stock market in the second half of the 1980s. In France, selective rediscounting was similarly replaced by a system of selective credit ceilings in the 1970s, and these were subsequently abolished under the first Socialist government of the 1980s at the same time as credit markets were overhauled to allow for a major rise in securities-based corporate finance over the following decades (see Loriaux 1991 and Cerny 1989). In all three countries, these changes were accompanied by the attribution of new supervisory powers over the banking sector to the national central bank and by introduction of new institutions to regulate securities markets.

In contrast to this radical pace of change in the principles guiding financial regulation in Britain, France and Spain, the regulation of finance in Germany and Italy experienced a remarkable degree of stability during the 1970s and 1980s. In neither country did governments introduce any fundamental changes in credit regulation, and reforms of other markets, in particular the stock markets, remained very modest. No major alteration of the principles governing corporate finance occurred. In the case of Germany, the reform of the securities markets was limited to changes in the way in which the stock markets were managed so as to lessen the influence of the smaller regional exchanges. But universal banks kept their central role in the market (Lütz 1998). In Italy, the government retained its political control over a substantial segment of the credit market through its continued control of the IRI, and there were no significant reforms to the regime of credit regulation or other elements of the financial system (see Deeg and Perez 2000)

This contrast between intense regulatory change in Britain, France and Spain, on the one hand, and continuity in Germany and Italy, is striking, in particular as the character of financial systems within each of these groups was very disparate. The financial system of Great Britain, defined by the division between deposit and merchant banks and the prominent role of securities markets, was quite different from that of France and Spain, with their state-directed credit systems and limited capital markets. The same can be said about the private-bank-organized financial system of West Germany and the state-dominated banking system that persisted in Italy. There is thus little clear order to the cross-national pattern we observe in this period if we look at it in terms of the traditional distinction between state and market, or bank- and security based-, systems. How then can we account for the pattern?

The prevalent view of the regulatory reforms of this period emphasizes the lack of viability of credit controls in a world of rising cross-border capital flows and the availability of new exit options for financial investors who could seek better returns in places that produced more allocative efficiency and hence higher returns (for example Goodman and Pauly, 1993). And indeed, the reform efforts of all three of the countries that undertook credit deregulation in the 1970s and 1980s were couched in the language of market efficiency, seeming to lend support to the view that pressure from financial market actors was the main causal mechanism behind regulatory reform. Yet if reform was driven principally by the threat of regulation-evading capital flight, we would expect greater regulatory change in those countries with the less liberalized

financial systems, and less change in countries that already had more liberalized financial systems. This does not seem to be borne out by our cases. Table 1 shows an index of financial liberalization constructed by Abiad and Mody (2003) ranging from 0 (defined as full repression of financial transactions) to 18 (defined as full liberalization). The index is based on several measures, including credit controls (including selective regulation of credits depending on the recipients and reserve requirements), interest rate controls (including floors and ceilings), barriers to entry in the banking sector, securities markets regulations, the degree of privatization in the financial sector, and restrictions on international financial transactions. It suggests that among four of our five cases (the index is not available for Spain), Germany and Britain had the most liberalized financial systems in the early 1970s, and France and Italy the least liberalized. France's relatively early move to overhaul its financial system and Germany's lack of regulatory reform from the 1970s through the mid 1980s might have been accounted for by the fact that France started out with a highly "repressed" financial system - and hence, presumably would have faced a greater market pressures - and Germany with a far less "repressed" one (and hence, presumably, would have faced less pressure). Yet the argument falls apart when we move to the other cases. Thus, it is unclear why Britain, with one of the least "repressed" systems, would have been pushed to undertaken a major regulatory overhaul in the 1970s, while Italy, with one of the most repressed systems and a higher reliance on foreign capital than any of the other countries, was not.

Table 1

Financial Liberalization Index (0 = Full Repression; 18 = Full Liberalization)			
	1973	1980	1987
Germany	16	16	16
Britain	12	15	18
France	5	5	13
Italy	5	6	6
Based on Abiad and Mody (2003), p. 86			

There are further reasons why the market-driven view of financial liberalization does not provide an adequate explanation for the cross-national pattern that we observe in the 1970s and 1980s. There are two causal mechanisms whereby the emergence of international financial markets might induce politicians to opt for financial market deregulation. The first is by shifting the preferences of domestic financial market actors leading to political pressures for liberalization. The second is by creating new exit options for investors resulting in capital outflows and the threat of full-fledged capital flight. If new international market opportunities were the catalyst for reform, we should see evidence for at least one of the two mechanisms at work in our cases. That is to say, we should find evidence for at least one of the following empirical implications. If a shift in the preferences of domestic market actors was behind reform, we should find that liberalization was actively promoted by members of the financial sector. If the threat of capital flight induced credit deregulation, we should find that external capital controls were becoming so ineffective as to undermine attempts to regulate credit selectively.

None of the three cases in which credit deregulation took place offers evidence of either type of causal mechanism. Concerning the first mechanism, the principal agents behind the

regulatory turn in all cases were public officials and there is little evidence of a connection between the timing of the reforms and political pressure from the kinds of sectoral actors suggested in market-driven explanations of reform. Indeed the most strongly affected sectoral actors – large commercial banks – adamantly opposed the reforms at the time of their initiation in Spain, and had serious apprehensions about them in France (Loriaux 1991, Perez 1997). Nor did foreign banks play a significant role. Indeed, they were actively discriminated against in the course of the reforms in Spain. Only in Britain can one argue that sectoral actors – in this case, international merchant banks – actively favored reform. Yet this only applies to the reform of the stock market. As far as the prior step of credit deregulation was concerned, the principal actors – i.e., clearing banks – opposed the move in 1972 and 1979 (Westrup 2005).

There is also little evidence for the second type of causal mechanism whereby market pressures might have forced reforms. If the growth of international financial markets had undermined the viability of external capital controls, producing capital outflows to the point of compelling domestic credit deregulation, we would expect such credit deregulation to have been followed – in relatively short order – by the dismantling of external controls. Yet in France and Spain external capital controls were not dismantled until the very end of the 1980s and the beginning of the 1990s, and then only in compliance with new EC directives. The notion that external capital controls could no longer be sustained is also contradicted by the substantial interest rate differentials between offshore and domestic interest rates that persisted in the European Exchange Rate Mechanism (ERM) until the end of the 1980s (which suggest that capital controls remained quite effective in shielding weak currency economies [de Grauwe 1990]) and by the huge rise in cross-border flows that followed after controls were dismantled in 1989 (Artus and Bourguinat 1994). Moreover, it is entirely unclear why Italy, which was more dependent on foreign capital than Britain, France or Spain, would see no major changes to its system of financial regulation until the mid-1990s, when its state-controlled banks were privatized. Indeed, the connection between internal reforms and external liberalization seems to have been the opposite of what the market-driven view suggests: the dismantling of external controls was part of a broad effort by governments such as the French to capitalize at the EU level on domestic reforms that had been initiated a good deal earlier for another set of reasons.

Yet if the early turn towards regulatory reform was neither compelled by capital flight nor the result of political pressure from market actors, what explains the early decision of public officials in favor of credit liberalization in Britain, France and Spain in the 1970s and 1980s and the absence of major regulatory changes in Italy and Germany during this period? We propose that the explanation for this cross-national pattern lies in political considerations by public officials that had less to do with market pressures than with the relationship that financial regulation held to macro-economic policy in each country. More specifically, the move to abandon credit controls of various sorts in Britain, France and Spain was driven in the first instance by the political difficulties that credit controls in those countries created for elected governments when those governments set out to fight inflation.

One thing that the British regulatory regime of overall credit ceilings and quantitative credit controls shared with the interventionist modes of selective credit regulation in France and Spain – and that sets these three cases apart from both the private-bank-based German system and the state-controlled banking system in Italy – was the fact that credit policy incorporated the instruments of monetary policy. In France and Spain, selective credit regulation, consisting

mostly of selective credit rediscounting, was instituted in the 1950s and 1960s precisely as a way of reconciling the preference of governments for a loose credit policy with the imperatives of currency convertibility. (It allowed authorities to gain some measure of control over monetary expansion without hurting credit to those sectors that they sought to favor at those times when currencies came under external pressure and without moving to a more orthodox monetary policy regime.) Similarly, in Britain, quantitative credit controls were instituted as an instrument that allowed for ad hoc adjustments in monetary policy when Britain's generally accommodating monetary policy stance threatened the value of the pound. By contrast, the German and Italian modes of financial regulation, however different from each other, were developed in the context of export-led growth strategies premised on price stability that led early elites to place the main instruments of monetary policy in the hands of autonomous, or functionally autonomous monetary authorities. Hence Italian political elites resorted to their direct political control over state-owned banks rather than to any comprehensive scheme to regulate credit, while German political elites limited their reach over credit markets to circumscribed export credit schemes, leaving overall credit regulation in the hands of the autonomous Bundesbank.²

It is this central – yet much overlooked – relationship between modes of credit regulation and macro-economic strategies (summarized in Table 2) that offers an explanation for the cross-national pattern of financial reform that we see in the period leading up to the 1990s. For, if credit controls were introduced in Britain, France and Spain to make viable an accommodating monetary stance, that same regulatory framework turned into a serious political liability once the supply shocks of the 1970s forced elected authorities to turn to the problem of inflation.

Table 2

Macroeconomic- Growth Strategy	Regulatory Outcome		
	<i>Non-statist/ PrivateBank Organized</i>	<i>Selective and/or Comprehensive Credit Controls</i>	<i>Direct Political Control</i>
Cheap Credit-Driven/ Subordinated Monetary Policy		France, Spain , Britain	
Export-Oriented/Price- stability premised	Germany		Italy

As long as the general tenor of credit policy remained accommodating, credit controls consisted primarily of the selective rediscounting (i.e. selective expansion) of credit by the central banks in France and Spain, and of punctuated restrictions in the British case. With the

²This feature of postwar regimes of financial regulation can be linked to early choices made by political elites regarding how to deal with inflated currency pools left over from wartime (Perez 1998). In both Germany and Italy, postwar authorities opted for radical currency reforms that set the stage for export-led growth strategies predicated on price stability. In France, Spain and Britain, by contrast, financial regulation was shaped by the decision against radical monetary stabilization in the 1940s.

problem of stagflation, however, the principal problem for monetary policy became that of stopping wage-price spirals, and thus of highly explicit and lasting credit restrictions. Thus, the shift in regulation that we see in France and Spain is that from selective rediscounting to selective restrictions, via ceilings (in France), compulsory coefficients (in Spain), and, in the British case, toward a much more intensive use of quantitative controls following the failure of Competition and Credit Control (CCC) in 1973.³ In none of the three countries were governments able to sustain a consistent disinflation process by these means. Thus, the second round of change in each country was to abandon credit controls in favor of a model in which monetary policy was carried out in a routine fashion by national central banks operating in newly created money and public debt markets.

The principal reasons for this early embrace of financial liberalization in the three countries were political rather than imposed by economic actors. Although central bankers advance a number of technical arguments for why monetary control is better achieved through indirect central bank operations than through direct credit controls – including the bluntness of controls in addressing short-term liquidity fluctuations and the incentives they create for financial innovation aimed at evading regulation – all three governments were relatively successful at imposing monetary rigor through quantitative controls at those points in time when they chose to abide by their targets. In the late 1970s, the French government, for example, came just as close to meeting its monetary targets by way of its system of credit ceilings as did the German Bundesbank, which relied on central bank operations (OECD 1983, 1984: 30). Thus, if explicit controls over credit limited the capacity of public officials to fight inflation, they did so primarily because they raised the political profile, and hence the political costs for governments, of measures to impose monetary rigor. While controls were in effect, governments were continually under pressure to expand exemptions marked for specific users of credit (see Loariaux 1991, Perez 1997). By contrast, when credit growth is controlled by a central bank through routine operations in a money market, monetary rigor is politically easier because it leaves the allocation of hardship to the presumed neutrality of the market.

These political considerations constituted an important incentive for elected authorities to embrace the arguments of advocates of liberalization at particular points in time. It fits the differing timing with which the commitment to abandon credit controls regulation was made. Thus, in Spain, the fundamental package of measures was pushed through in the throes of the political regime transition (1977), when authorities faced the dual tasks of thwarting an explosion in wages while simultaneously initiating a democratic process of policymaking. In France the decision to abandon selective credit regulation was made only after 1983, when elected authorities (Mitterrand) decided that austerity would be unavoidable. In Britain, it was only after the political fallout of attempts to impose disinflation through quantitative controls had materialized that those controls were abandoned and that the Bank of England was given effective control over money markets as part of the 1979 Banking Act.⁴

This political explanation of why credit controls were ended also fits the relative absence of institutional changes in Germany and Italy during this period. While Italy's financial system

³The adoption of CCC in 1971 involved the move from an administratively set Bank Rate to a Minimum Lending Rate. It resulted in a dramatic explosion of credit and a rapid rise in inflation over 1972 and 1973.

⁴An earlier attempt to lift all controls in the early 1970s failed as it was not backed by the necessary measures to allow the Bank of England effective control over money markets.

remained markedly statist (given the political control of the IRI and the Bank of Italy's use of administrative controls) and Germany's was not, neither country's regime of credit regulation interfered with the overall tenor of monetary policy. In Germany that policy had been in the hands of an independent central bank since the 1950s. And in Italy, the Bank of Italy had long exercised *de facto* control over monetary policy, even while it was formally subordinated to the Treasury and had a legal obligation to monetize Treasury shortfalls until 1981. Thus the political dynamic whereby credit regulation raised the political salience of unpopular monetary policy measures did not ensue, and political authorities faced fewer incentives to initiate an overhaul of the system of financial regulation

Seen in this light, the cross-national pattern of regulatory reform in the 1970s and 1980s was intimately linked to the differing roles that monetary expansion had played in postwar economic strategies, and to the way in which those strategies had affected the design of postwar regulatory regimes for credit. It was that relationship to the politics of macro-economic policy, rather than pressures on governments stemming from international markets, which provided the common motivation for political elites in Britain, France and Spain to embark on the first wave of credit deregulation. The decision to boost the role of capital markets followed from this first phase of regulatory reform. And although capital market reform was, in turn, subject to a different set of political considerations, the point here is that it occurred first in those countries where governments had been led to embark on a course of regulatory reform by the political costs that their postwar framework of credit regulation imposed on them in an era of stagflation.

II. The second wave of regulatory reforms

While in the 1970s and 1980s the principal events in the area of financial regulation involved the abandonment of credit controls followed by the overhauling of stock markets, the 1990s have been a period in which financial reform has been dominated by efforts to strengthen the supervision of the financial sector by public authorities. From a cross-national perspective, the principal outcomes to be noted during this period are, first, an across-the board intensification of the supervision of different elements of the financial system (banking, securities, insurance) by public authorities that has manifested itself in an increase in legislation concerning standards of governance, new regulatory institutions and, generally speaking, an increased role for the state in these matters; and, second, divergence in the institutional models whereby this new, intensified supervisory role of the state is being applied. Britain and Germany have opted for a single financial regulator, while France, Italy and Spain have maintained a functional separation between banking, securities and insurance regulators. A particularly noteworthy and, we consider, crucial aspect of this contrast in institutional responses concerns the role of the central banks. In the British case, the Bank of England no longer has any role in regulation, and in Germany, the Bundesbank has been rejected in its attempts to expand its regulatory role beyond a broadly implementationary one, whereas in our other three cases, the respective central banks have maintained their roles as prudential regulators of banking institutions.

In this section, we explore some reasons why state actors' interest in market supervision has increased, and why we see different institutional responses. We argue that, aside from the external pressures highlighted by other authors, the salience of prudential regulation and the supervisory role of the state have increased because of changes in the composition of domestic

savings markets. As in the case of postwar regulatory regimes and the earlier turn towards credit deregulation, there is a link between the new regulatory turn and macro-economic policy choices: the changes in savings markets that we point to are largely the result of efforts by governments to attain fiscal consolidation by way of the privatization of state assets and the promotion of private pensions as part of welfare reform. On the other hand, in understanding the divergence in institutional responses, we point to the emergence of a split in this period between two types of state actors, namely the governments and central banks, which had operated mostly as allies in the previous period of regulatory reform. This split, we suggest, has taken on particular salience in the cases of Britain and Germany.

Regulatory Reform in the 1990s

In the previous section we described the main differences in postwar financial regimes among our five European cases in the key area of credit regulation and its relationship to monetary policy. By contrast to this divergence in credit regulation, one characteristic of postwar financial regulation that was similar across all cases was the low intensity, if not absence, of regulation of a supervisory nature; that is, regulation aimed at the character of competition, business conduct and prudential standards in the financial sector. In the three cases where the banking system remained predominantly in private hands after the war (Britain, Germany and Spain) there was a heavy reliance on self-regulation by the sector in regard to all these matters. Indeed, commercial banks were cartelized in Britain and Spain, somewhat less so in Germany.⁵ Securities markets in all five of our cases were also characterized by the absence of public supervision and by a limited degree of competition among market agents.⁶

In Britain neither the state nor the Bank of England had legislative powers to supervise banking institutions until the Banking Act of 1979, which established the BoE's supervisory role over banking.⁷ It was not until 1986 that the Securities and Investment Board was created to oversee the securities market, and it was created as what Moran describes as a mesocorporatist body with regulatory responsibility shared between state and market actors (Moran 1991).

In Spain, banking regulation was the purview of a High Banking Council presided over by the head of the Treasury, but controlled by the seven largest commercial banks which, like the British case, operated as a cartel and were the principal players in the stock market (Perez 1997). In Germany, the Bundesaufsichtsamt für das Kreditwesen (BaKred), a government agency created in 1961 to supervise the banking system (the strongest example of an effort at public supervision of private banks), nonetheless shared with the Bundesbank a philosophy of minimum intervention and limited its role to establishing a general framework of rules through close consultation with the banking sector, rendering the regime highly corporatist in nature (Busch, 2000; Coleman 1996).

⁵In the latter case, the semi-public, local savings banks served to insure more competitive conditions in the market for corporate finance for smaller firms (Deeg, 1999)).

⁶Not surprisingly, in all four of the bank-based countries, capital markets retained a very narrow character as corporate finance was dominated by bank credit, although this had not always been the case. The French stock market, for instance, had played quite an important role in the 1920s, yet was decimated by the state-implemented policy of cheap credit after World War II.

⁷Clearing banks operated openly as a banking cartel within the context of state credit controls (Budd, 2002).

In the 1990s, by contrast, we see the emergence of new supervisory institutions that bring to an end the norm of self-regulation. Most dramatic in this regard has been the concentration of regulatory functions under a new overarching institution (the Financial Services Authority) by the Labour government in Britain, ending both self-regulation in the securities markets and the regulatory role of the Bank of England (Westrup 2007). A similar, if differently organized, concentration of regulatory functions was established in Germany in 2002, with the creation of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), which now covers the functions of the Bundesaufsichtsamt für den Wertpapierhandel (BAWe), the securities regulator created in 1996), BaKred (the institution overseeing prudential standards in the banking sector since 1961), and Bundesaufsichtsamt für das Versicherungswesen (BaV), the insurance regulator.⁸

In the other three countries, while new institutions were introduced and supervisory powers intensified, we see the continuation of a multiplicity of regulatory agencies with responsibility for supervision of the financial system. In France, a new securities regulator (the Conseil des Marchés Financiers (CMF) was created in 1997 and later merged with the Commission des Opérations de Bourse (COB) to form L'Autorité des Marchés Financiers (AMF) in 2003. However, the Commission Bancaire still regulates the banking sector and the French Insurance Supervisory Authority continues to regulate the insurance sector. In Italy, the Bank of Italy's supervisory powers over financial intermediaries were strengthened in 1993 and so were the powers of Italy's securities regulator, the Commissione Nazionale per le Società e la Borsa (Consob) in 1998. Yet the central bank has retained its oversight of the banking sector. Finally in Spain, as in France, adjustments have been made to financial regulation in accordance with the EU's Investment Services Directive (ISD), but regulation remains split three ways between the Bank of Spain (banking), CNMV (markets) and Directorate of Pension and Insurance Funds (DGS).

This turn in the course of financial regulation presents us with two questions. The first is the question of why state actors across the board have sought to intensify the supervision of the financial sector in the last decade whereas they had continued to rely on self-regulation even as liberalization and stock-market reform took place during the 1980s. The second is why governments are opting for different institutional structures in their efforts to enforce such supervision.

Turning to the first question, the focus on prudential regulation and market supervision in the last decade is often attributed to a particular set of external forces: 1) "financial globalization" (Strange 1996, Held et al 1999), which has led states to look to international organizations, such as the Bank for International Settlement (BIS) and the International Organization of Securities Commissions (IOSCO), and international agreements such as Basel 1 and 11, as a means of imposing standards and of monitoring compliance in the context of open financial markets (Simmons 2001, Pauly 2002); 2) a process of Americanization which is attributed to the influence of American financial institutions and investors in world markets (Moran 1991, Laurence 2001); and 3) Europeanization by way of EU directives such as the Banking directives which mandate capital standards similar to those agreed to in the Basel accords and also the Investment Services Directive.

It is undeniable that all three features of the external context listed have influenced regulatory reforms during the 1990s. However, they cannot explain the abandonment of the prin-

⁸The Bundesbank still carries out the on-site regulation of banking institutions.

principle of self-regulation and the increase in state oversight. Neither the capital adequacy guidelines of the BIS or European directives, nor Americanization, required the creation of agencies accountable to the executive such as have been introduced in Britain and Germany.

There is, however, another development that can serve to explain why governments would be motivated to seek an intensification of state supervision, namely the significant changes we see in domestic savings markets over the last two decades.

Table 3. Composition of household assets (in % of gross financial assets)

		1980	1990	2000
Britain	<u>Deposits</u>	43	31	22
	<u>Risk Assets</u>	53	61	74
	Bonds	7	1	1
	Equities	12	12	17
	Institutions	30	48	56
Germany	<u>Deposits</u>	59	48	34
	<u>Risk Assets</u>	33	44	60
	Bonds	12	16	10
	Equities	4	7	16
	Institutions	17	21	34
France	<u>Deposits</u>	59	38	25
	<u>Risk Assets</u>	30	56	61
	Bonds	9	4	2
	Equities	12	26	37
	Institutions	9	26	23
Italy	<u>Deposits</u>	58	35	25
	<u>Risk Assets</u>	24	48	75
	Bonds	8	19	19
	Equities	10	21	26
	Institutions	6	8	30
Spain**	Deposits	66	62	36
	Risk Assets	21		64
	Bonds	5	7	2
	Equities	14	26	34
	Institutions	2	18	28

Source: Davis (2003), *OECD-OEE/Pioneer Investment Research 2001 and Cuentas Financieras de la Economía Española (1982-1991), Madrid: Bank of Spain, 1992.

** Figures shown for Spain in the 1980 column are for 1982, the first year data is available.

As Table 3 shows, there was in all five of our countries a marked shift in the structure of household savings, away from secure assets such as bank deposits (which constituted the principal savings vehicle for households in 1980) toward risk assets (including most notably holdings of equity and investments placed in securities markets through institutional investors). Between 1980 and 2000, the total proportion of risk assets (which also include bonds) rose from 53 to 74 percent of household savings in Britain, from 33 to 60 percent in Germany, 30 to 61 percent in France, 24 to 75 percent in Italy, and 21 to 64 percent in Spain. Among risk assets, we also see a marked decline in the proportion held in bonds (the least risky of “risk assets”) in favor of riskier investments in all countries but Italy, which, on the other hand, has seen the single most dramatic change in the allocation of household savings.⁹

The shift in the structure of household financial assets from bank deposits to risk assets has important political implications for elected authorities. The vulnerability of large segments of the electorate to market events has dramatically raised the political salience of financial supervision, raising the costs for political authorities of supervisory failures. That new political risk becomes all the more significant as authorities beyond Britain consider moves to shift the weight of old-age income provision from public to private pensions. Prior to the 1990s, bank deposits dominated the portfolios of most households in all five of our countries, and prudential regulation was of interest almost exclusively to technocrats, predominately central bankers and senior civil servants, but not to elected officials. The primary reason for the lack of interest by elected authorities was the low political cost of regulatory failure, since, in the event of a banking failure, central banks could carry out a traditional lender-of-last-resort function, bringing in other domestic banks to assist if necessary. The rise in the role of investment funds, pension funds and individual stock ownership, however, has raised the potential political cost of regulatory failures for elected officials, increasingly putting them at odds with technocratic elites, particularly central banks, to whom they had previously delegated control of such regulation. This has created new incentives for governments to seek to intensify state supervision of financial markets and, in some cases, to reassert their control over them by centralizing financial regulation in a single regulatory agency accountable to the political executive (as has been done in Britain, and more recently in Germany).

One example of this new political salience of financial supervision was the pension mis-selling scandal of the 1990s in Britain, which followed the Thatcher government’s policy of encouraging private pensions through fiscal incentives, leading some seven million people to opt out of both SERPS (State Earnings Retirement Pension Scheme) and occupational schemes in favor of personal pensions, before it emerged that people were persuaded to opt out of schemes against their best interests (Institute of Fiscal Studies 2000). The scandal proved to be highly politically controversial and expensive for large financial institutions (which were forced to reimburse some 1.6 million people at a cost of £11.5 billion, and it prompted an immediate review of the regulatory system [FSA 2001]). Another example is the 1993 failure of Banesto in Spain, which affected as many as 300,000 small shareholders, and played into the Socialist electoral defeat of 1996. Yet another prominent example is that of Parmalat in Italy. Though Italy is one of the countries that has not drastically altered its supervisory institutions, the scandal was largely blamed on the supervisory failure of the Bank of Italy and Consob, which share responsibility

⁹ It is also noteworthy that Italy has long had the most developed of corporate bond markets which offer a greater risk and return than government bonds.

for bond markets, and it led Finance Minister Tremonti to call for a major overhaul of those institutions in favor of a new, overarching regulatory agency (*Financial Times* 2004). The fact that this call was not heeded is one of the questions we will take up in the next section.

What the change in the structure of savings has done is to bring to the fore the question of political accountability for market failures, raising what was once the “low” politics of financial sector regulation to a new status of “high” politics. This provides us with an explanation for why governments across the board have chosen to increase state supervision of the financial sector even when external actors, in particular international investors and international financial institutions, have not demanded such change. Such an explanation is also more compatible with the variation in institutional models that we see governments opting for, as it does not depend on the notion of an external enforcement mechanism to account for regulatory change. On the other hand, it does not explain that pattern of variation in institutional responses. We will turn to this question in the next section.

Before doing so, however, we must point out that the change in the structure of domestic savings markets that has occurred is itself the consequence of policy choices in the area of fiscal policy and welfare reform. Although stock market reforms have been guided at least in part by the goal of attracting investment in a context of globally mobile capital, this facilitated, but did not itself produce, the shift in the allocation of household savings. Two other forces were far more important in this regard. First, the mass privatization of large public enterprises, in particular public utilities, which offered new investment possibilities to small investors, starting with Britain (British Telecom, British Gas, BP, BA and British Steel, France (Suez, Société Générale, and Compagnie Générale d’Electricité), Spain (Telefónica, Repsol, and Endesa), Germany (Veba, Deutsche Telekom) and Italy (Mediobanca). Secondly, the expansion of share ownership across Europe has been strongly encouraged by important tax incentives offered by governments to encourage long-term savings among households (a move usually connected to welfare and in particular pension reform).¹⁰ Examples include tax relief for direct and indirect equity ownership in Britain via the introduction of Personal Equity Plans in 1987 and that of U.S.-style Individual Savings Accounts in 1999, tax relief for life insurance and the Riesterrente in Germany, “voluntary wage savings partnership plans” introduced by the French Socialists in 2001, and tax relief for mutual fund and private pension investments in Spain (see Institute for Fiscal Studies 2000; Davis and Steil 2001; Clark 2003). The rise in direct and indirect risk asset holdings of private households, and hence the political pressure to increase state supervision over the financial system, thus have been foremost the result of policy choices made in response to the fiscal pressures on national budgets and pension systems.

Central Banks and Regulatory Models

The rise in the domestic political salience of financial regulation offers an explanation for the turn towards increased state supervision that is, at the same time, more compatible with the finding of different institutional responses than explanations that attribute regulatory reform to

¹⁰Although the ideological objective of spreading popular capitalism was a factor in some of these campaigns (notably the Thatcher government), the process was dominated by fiscal policy considerations (fiscal consolidation and reducing the burden on public pensions) in virtually all cases. There is evidence that this is true even in the British case (Lawson 1991).

external market forces. This is because a process driven by domestic political considerations leaves more room for the influence of other factors in determining institutional responses than one driven by a common set of external market forces. To understand the different institutional responses, we propose to look at how the increased political costs associated with financial market failures has altered the relationship between two actors whose interests tended to dovetail in the previous decades: elected governments and central bankers. The latter have typically played the role of default regulators over the financial system, and tended to act in unison with elected authorities when it came to questions of credit regulation and justifying anti-inflationary policies. Yet the changes described above in the composition of domestic savings markets set things up for a potential rift in the interests of these two state actors. This is particularly the case, we will suggest, where governments are putting their weight behind efforts to boost the role of funded private pensions, as in Britain and Germany.

Before moving on to consider the likely reasons for the different institutional models adopted in EU countries in recent years, it will help to review these differences and to consider the main normative arguments offered by economists in explaining these models of financial supervision. As already noted, the main difference we observe among our five cases is that between the choice in favor of a single regulatory agency that oversees all sectors of the financial system and is accountable to the political executive (Britain and Germany), and the option of retaining different regulators for different segments of the financial system, and in particular, the authority of autonomous central bankers over the banking system (France, Spain, and Italy).

In Britain and Germany, with the creation of the Financial Services Authority (FSA) and the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), all sectors are now under the supervision of a single regulator accountable to the political executive. Although the internal organization of the two agencies differs in that regulatory responsibilities within the BaFin are still largely divided on functional grounds whereas the FSA has a more fully centralized structure, they have one important commonality, namely, that they are accountable to the political executive. In this regard they differ fundamentally from the norm in the other three countries, which not only maintain different regulators for different segments of the financial system, but these regulatory agencies (central banks, insurance and securities regulators) also have the status of autonomous governmental bodies that are specifically shielded from interference by elected authorities. As Moran points out, the FSA “has a radically different relationship with the central state from that enjoyed by the old institutions of City regulations and the Bank of England. The Treasury appoints its Board, it reports annually to the Treasury and the House of Commons, and is required to give evidence to the Treasury Select Committee” (Moran 2003). In the case of BaFin, there is also a clear change in the accountability structure. The new institution is controlled by an administrative council comprised of twenty-one members, including four from the Finance ministry (including the chair), one from the Economics and Labor ministry, one from the Justice ministry, five from the Bundestag and ten from the financial services industry. The chair of BaFin reports regularly to the Bundestag finance committee. And even though the old regulatory agencies survive under the oversight of the BaFin, the latter has already proved its regulatory muscle in issues such as the negotiation of the German position at the Basel II discussions, the decision to begin to implement risk appraisals of banks’ lending portfolios, and the delicate

negotiations about the solvency ratios of German insurance companies.¹¹ As with the FSA, the creation of BaFin has proven that German political authorities want a financial regulator that is powerful but also accountable to the democratic process.

As Table 4 indicates, this regulatory trend goes beyond just the five countries under consideration here, with several other states in Europe also moving to the single regulator model. Others, however, have retained either a two or a three regulator model, maintaining the institutional separation along functional lines of banking, securities and insurance. In Italy, we observe relatively little institutional change that has not been inspired directly by EU directives of prudential supervision. Such was the case with the Consolidated Banking Law of 1993 which gave the Banca d'Italia (BdI) extended supervisory powers, followed by the 1998 Consolidated Law on Finance, which both strengthened securities regulation and transferred specific responsibility for conduct of business from the BdI to Consob. Significantly, the BdI has retained control of the prudential regulation of not only banks but also security firms and the very important bond market, this in spite of a number of major scandals involving the BdI. (The BdI also retains a key role in deciding upon appropriate levels of competition, which has proven significant in so far as it has prevented foreign takeovers of Italian banks). In France, as in Spain, it is only the securities markets that have seen significant institutional change among French regulatory institutions since the banking and stock exchange reforms of the eighties. First in 1996, the Conseil des Marchés Financiers (CMF) was created to oversee the regulation of markets, partly as a response to the EU Investment Services Directive. The CMF was then merged with the COB in 2003 to create the Autorité des Marchés Financiers (AMF). The AMF has the full powers of a securities regulator and has been given a legal personality distinct from the state, unlike France's other administrative authorities (AMF 2003). The Banque de France still retains the lead in banking regulation through its oversight of the Commission Bancaire.

Table 4 : Financial Regulatory Models (EU 15)

Single Regulator	Two Regulators	Three Regulators
Denmark (1988)	Netherlands (2004)	France
Sweden (1991)	Luxembourg (1998)	Italy
Britain (1997)	Finland (1993)	Spain
Germany (2002)		Greece
Austria (2002)		Portugal
Ireland (2003)		
Belgium (2004)		

Source: Davies 2004

Economists and policy experts offer several arguments for why the institutional structure of financial regulation should change in favor of a single regulator. First, with "financial globalization," the lines between types of financial institutions and the products they sell have become increasingly blurred over time. (An example is the rise in "bancassurance," or the merging of banks and insurance companies to reflect the increasing similarity of certain banking and insurance products and the involvement of banks in securities trading and fund management.)

¹¹Jochen Sanio as chairman has a high political profile and all the important private actors involved in German financial regulation appear to take it seriously (IMF 2003).

It is argued that a single regulator is better able to understand the total risk profile of a financial institution in these situations (Davies 2004, Padoa Schioppa 2004). A second set of arguments involves the identity of the regulatory agency – specifically the positioning of central banks. As savings and capital markets were predominately bank-based in the pre-reform period, it was central banks that emerged as the most powerful regulatory agents in most European countries as self-regulatory bodies were abolished. Yet leaving financial regulation in the hands of central banks as capital markets expand presents the risks of extending them outside their traditional area of expertise and of regulatory overload. In addition, because central banks have traditionally acted as lenders of last resort, there is a risk of increased “moral hazard” when such a safety net is extended to other types of institutions (Goodhart 2002). Thirdly, the problem of allowing the central bank to become a “super-regulator” is compounded by the decisions of governments to grant these institutions statutory autonomy in order to depoliticize monetary policy and reduce inflationary expectations (Cukierman 1992). When the regulatory mandate of central banks is extended to new areas of financial sector regulation, there is a concentration of regulatory power and a lack of political accountability in an area where such a condition has not necessarily been justified.

On the other hand, there are also arguments in favor of an alternative, “Twin Peaks” option of two regulators. This alternative allows for a division in responsibility between two key objectives of supervision, the promotion of systemic stability and customer protection, and preserves the benefits conferred by the expertise of central banks as prudential regulators looking out for the stability of the financial system (Goodhart 2002) (Padoa-Schioppa 2004).

These theoretical arguments have mostly been mustered in the debate over whether or not the EU should create a separate, EU-wide supervisory authority to match the centralization of monetary policy functions in the ECB (Padoa-Schioppa 2004), a move for which there are few prospects as long as the national regulatory models remain as relatively diverse as Table 2 indicates. They do not of themselves, however, offer much traction in explaining the pattern of diversity that we see. The types of problems spelled out in the policy debate apply equally to the cases we consider. And there is little evidence that the prevalence of any particular theoretical viewpoint determined the choice of regulatory structure in the five countries.

Nonetheless, the policy debate on the benefits of different institutional arrangements does offer an important clue as to the politics behind the diverse institutional responses in different European countries by focusing our attention on the role of central banks. One way to look at these diverging results is that the choice between introducing a single, politically accountable regulator or maintaining the traditional division of labor among regulatory agencies in practice centers on the question of whether or not to subordinate the central banks (as noted, traditionally the most powerful regulator) to a new, overarching and politically accountable agency. The new political salience of financial regulation can pit elected government officials against autonomous central bankers. It can lead elected authorities, who are held accountable for financial market failures, to seek control over supervision, while central bankers, who had gained powers from such measures as credit deregulation and the initial expansion of supervisory regulation, seek to maintain their regulatory authority. This latent conflict is likely to be particularly acute in the EU, where central banks have ceded their monetary policy authority upward to the ECB, so that their domestic role now centers exclusively on their regulatory powers (Davies 2004). In this context, other factors that affect the position of strength of central

banks vis à vis elected governments are likely to become important in determining regulatory outcomes.

In both the British and German cases, the creation of single regulatory agencies involved an important struggle with domestic central bankers. In the case of Britain, the New Labour government's decision to create a new single regulatory agency to supervise the entire range of the financial services industry, including banking, was greeted with major surprise because, although the party had committed itself in its manifesto to reform of the Securities and Investments Board, the decision to strip the Bank of England of its regulatory powers was completely unexpected.¹² The decision was greeted with fury by the Governor of the Bank of England, who apparently considered resignation (Keegan 2003). Yet, the continued high-profile failures of the previous regulatory regime (including the pensions mis-selling scandal and the BCCI scandal) weakened the political capability of both the BoE and key private actors such as the banks and the insurance companies to argue against the case for the FSA. Indeed, it is significant to notice how muted the reaction of private actors was to the government's decision. Given the high-profile regulatory failures of the Bank in the past, it was unthinkable to consider placing it in charge of an expanded supervisory agency. Thus the decision was either to create a new single regulator or to follow a Twin Peaks model and create a new prudential regulator to oversee all financial institutions, including the banks. In the end, the Treasury decided that the radical option was more appropriate, and neither the Bank nor its traditional clients were in a position to block it. In summary, the decision to create the FSA was an explicitly political one by the government with the clear objective of stating that financial regulation was too important, both politically and economically, to be determined by either an independent Central Bank or any degree of self-regulation (See Westrup 2007 for a full discussion).

In Germany, the rationale for, and path to, a comprehensive regulatory agency was somewhat different. Nonetheless, a key feature of the German government's decision to design the new BaFin was that it had to overcome the opposition of the Bundesbank, which up to that point had been a key member of the "Frankfurt coalition" responsible for the regulatory reforms of the early nineties, including the creation of the BaWe. (Luetz 1998, Coleman 1996). For the Bundesbank, it was not just a case of relinquishing responsibility for regulation but of seeking to increase it. During 1999 and 2000, it lobbied aggressively to increase its regulatory remit as it sought to find a new role following the ceding of monetary policy to the ECB. First, it argued that it should assume responsibility for all financial regulation and then, when the Finance ministry dismissed that suggestion, modified its proposed role to that of assuming responsibility for banking regulation by integrating the BaKred into the Bundesbank, in a manner analogous to the relationship between the Commission Bancaire and the Bank of France (Engelen 2001). The Länder (i.e., states) governments and the public sector banks broadly supported the Bundesbank in this position. However, the other components of the Frankfurt coalition, in particular the private banks and the Finance Ministry (under Hans Eichel), supported the creation of a single regulatory authority. In the end, it came down to an unexpected last-minute decision by Schroeder to side with those other members of the Frankfurt coalition, creating a major surprise with Eichel's January 2001 announcement. What may well have tipped the scale in the end was the fact that the decision on the new regulatory structure came to coincide with the govern-

¹²The *Economist* described the change as "astonishing and "a dramatic new plan for financial regulation." *The Economist*, May 24, 1997, p. 15.

ment's decision at almost the same time to move forward with a push toward private pensions by allowing German citizens to place part of their contributions in private accounts (the so-called the Riester Renten). That move was one in which the Schroeder government faced strong opposition (Busemeyer 2005; Hering 2004). And according to one 2001 article put out by the Deutsche Bank, "The increased significance of private retirement provision going forward ... [was] ... a major factor dictating the need for a change in supervisory structure" (Speyer, 2001).

Yet, if the increased vulnerability of citizens to market events and of political authorities to supervisory failures led British and German authorities to create new regulatory structures, why do we not see a similar set of decisions to replace the supervisory powers of the central banks with new, politically accountable regulators in the other three countries? This is particularly striking as these countries too have seen their share of financial scandals that might be attributed to supervisory failures in recent years (Credit Lyonnais, Vivendi, Banesto, and Parmalat).

One explanation that we can offer is that in all three of these countries, central banks were far better placed to defend their turf as a result of their central roles in acting as overseers of their country's participation in EMU. This seems to be particularly true in the Spanish and Italian cases, where the central banks attained a good deal of political capital over the previous decade, as both countries embarked on major efforts to meet the Maastricht convergence criteria. The statutory independence of these institutions is thus more easily cast in terms of autonomy from political corruption than as a lack of political accountability. The leading position of Spanish central bank reformers in defining economic policies in the post-Franco era has been amply documented (see Perez 1997). And in the Italian case, the perception of the Bank of Italy as an institution with unique credibility (at least until the Fazio affair) is manifested in the fact that two senior central bank officials (Ciampi and Dini) were appointed as prime ministers to oversee the government's campaigns to regain credibility both domestically and internationally in the face of the profound political crisis of the early nineties (Sbragia 2001).¹³

The French case is somewhat more difficult to explain. Yet here too it can be argued that the central bank has played a rather particular role. The decision not to subordinate this regulatory authority of the Bank of France to a politically accountable regulator may be the result of the BdF's particular role among French economic and political institutions. Traditionally, the Bank had relatively little independence from the Treasury and was part of the statist structure of the French state (Hall 1986). However, with the adoption of the *franc fort* policy in the mid-1980s the Bank became identified with France's ambition to create a strong role in the future of European monetary and exchange rate policy through EMU. Once it obtained its independence

¹³Nonetheless, there is increasing evidence of a split in the view of state actors in Italy following the Parmalat affair, which affected some 85,000 bond holders. In the aftermath of the scandal, finance minister Tremonti proposed the dramatic step of creating a "super authority" that would replace Consob and take regulatory powers away from the Bank of Italy, which held primary responsibility for the supervision of the bond market (*Financial Times* 2004), a proposal fiercely opposed by the Governor of the Bank. Although Tremonti subsequently resigned, and the Bank's supervisory role has continued, what is apparent is that the interests of state actors in Italian financial regulation are now more diverse than they were a decade ago.

in 1993, it continued to develop a reputation as a significant actor in European and global financial affairs.

Lastly, we would like to suggest a second factor that plays on the side of the motivation of governments to promote a single regulatory authority (rather than the ability of central banks to oppose such a move), namely, the relative weight attributed to private pensions in the process of pension reform across the five countries. While Britain stands apart in this regard from our other cases with its highly developed private and funded occupational pension schemes, it can be argued that the German government (under Schroeder) has taken a more decisive step to promote such pensions than governments have so far in Italy, France or Spain, with the introduction of the Riesterrente in 2001. Although the weight of private pensions in Germany does not come close to what we see in Britain, the move to reduce the income replacement rate of public pensions by allowing German citizens to place part of their contributions in private pensions constituted a watershed in German welfare reform that was carried out by the Schroeder government in 2001 against strong opposition (Hering 2004). With the exception of Britain, none of our other cases have seen a similarly decisive and politically salient move in favor of private pensions as a means to cut labor costs and ease the future fiscal cost of welfare provision. This has so far mitigated the pressure that governments face in these other countries to make financial regulators politically accountable. We would expect that any future moves to boost the role of private pensions (and thereby privatize the risk of old age pension provision) in these other countries would also increase the political salience of financial regulation and, therewith, political pressure to move in the direction of a unified and politically accountable regulator.

III. Conclusion

In this paper we have argued that, to a significant extent, the variation in the patterns of financial de-regulation and re-regulation across our five European cases over the last three decades has been a function of the way in which different postwar financial systems relate to the broader politics of macro-economic policy. In the 1970s and 1980s, it was those states which had developed systems of credit regulation that tended to subsume the instruments of monetary policy that were the first to engage in major changes in their modes of financial regulation. We have suggested that this was not just because of the technical obstacles that these particular forms of postwar regulation posed in the face of increased capital mobility. Far more centrally, it was because those systems tended to politicize attempts to control inflation, injecting state authorities into tough allocative choices (who would get credit and at what rate) thereby raising the political costs of disinflation. Regulatory regimes that did not have this particular characteristic, whether market-oriented or state-dominated, experienced far less change in this period.

In the 1990s, by contrast, regulatory reform centered on the intensification of state supervision over corporate governance and conduct of business in the financial sector. This we attribute to changes in the composition of domestic savings markets that were encouraged by fiscal policies aimed at reducing the size of the public sector and at shifting the burden of old age pension provision from the welfare state to individuals. The unintended effect of these policies has been to increase the political costs to elected authorities of financial market failures, and hence the political salience of financial regulation, creating new incentives for governments to seek to increase the state's supervisory role. Nonetheless, as in the first period of regulatory change, we see path dependence in the manner in which states have sought to address these challenges.

The increased political salience of financial market failures (calling for greater state supervision) was not only the consequence of earlier government policy choices. In those states (Spain, France and Italy) in which central banks played a role of leadership in the previous decade of regulatory reform, governments have preserved the supervisory role of these autonomous institutions. In Germany and Britain, by contrast, the central bank has been stripped of its supervisory role through the creation of new regulatory institutions that are either directly or indirectly accountable to elected authorities. This divergence in institutional responses presents a significant obstacle to the creation of a EU-level structure of financial sector regulation.

Our attention to the role of macro-economic choices and to the political calculations of elected elites has important implications for our understanding of the process of financial regulation. To the extent that these factors play a role in any process of reform, they may work in a different direction than a process driven by the efficiency-oriented dynamics postulated in views of reform as market-driven. Regulatory solutions that limit the political exposure of elected leaders may trump those that represent “best practice” from the standpoint of efficient capital markets. On the other hand, we note that the liberalizing and market-oriented reforms of the 1980s have, to some extent, had unintended consequences for political leaders. Our analysis hence suggests that we need to pay a great deal of attention to the way in which macro-economic reforms that expose a wider share of the electorate to market events raise questions of political accountability, and how this in turn affects the regulatory choices of governments.

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