discussion paper

P 02 - 901

The Transition from Banks to Markets in the German and Japanese Financial Systems

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August 2002

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ZITIERWEISE/CITATION

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Wissenschaftszentrum Berlin für Sozialforschung 2002
Working Group on Institutions, States, and Markets

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Abstract

One of the key features of both the German and Japanese postwar political economies is a bank-based financial system. In the 1980s bank-based systems were widely perceived to be superior to market-based systems like the US and UK in their ability to provide long-term "patient" capital to industry. Since the early 1990s, however, the bank-based financial systems in both Japan and Germany have faced serious challenges, to the extent that their fundamental viability vis-à-vis market-based systems is being questioned. This paper assesses the potential paths of development for these bank-based systems and argues that change in the two countries is poorly captured by the "convergence-divergence" dichotomy. The first point made is that an examination of changes in financial systems should start with an analysis of the "societal foundations" of bank-based systems. Bank-based systems rest not just on a set of financial regulatory practices but also on the institutions and behavior of the household, corporate and public sectors as savers and investors. The second point made in this paper is that, although public policy choices are often presented in terms of a stark dichotomy between "liberal" and "non-liberal" modes of regulation (the former associated with market-based systems, the latter with bank-based systems), in fact both Germany and Japan are struggling to find a successful combination or "hybrid" of the two types of financial regulation. A third and final point is that banks play important (if diminished) roles even in market-based systems. The ultimate form that the coexistence of banks and markets will take in Japan and Germany depends on the creativity and efforts of policymakers and the banks themselves. Those interested in institutional design should try to preserve a viable banking system for SMEs and the household sector while simultaneously promoting stable capital markets for larger companies and high-tech start-ups.

Zusammenfassung

Eines der Hauptmerkmale der politischen Ökonomien Deutschlands und Japans in der Nachkriegszeit ist das bankenbasierte Finanzsystem. In den 80er Jahren wurde dieses den marktbasierten Finanzsystemen weitgehend darin als überlegen betrachtet, der Industrie langfristige „geduldige“ Finanzmittel bereitzustellen. Mit Beginn der frühen 90er Jahre jedoch, sahen sich die bankenzentrierten Systeme Deutschlands und Japans mit derart gestalten Herausforderungen konfrontiert, dass sogar ihre grundsätzliche Überlebensfähigkeit gegenüber den markbasierten Systemen in Frage gestellt wurde. Dieses Papier beurteilt die möglichen Entwicklungswege der beiden bankenbasierten Systeme und vertritt die Meinung, dass die Wandlungsprozesse der beide Volkswirtschaften nur unzureichend durch die „Konvergenz – Divergenz“ Dichotomie beschrieben wird. Das erste Argument, das hierzu entwickelt wird, beschreibt die „gesellschaftlichen Grundlagen“ der bankenbasierten Systeme. Diese Systeme beruhen nicht alleine auf einer Reihe

von Finanzmarktregulierungen, sondern auch auf Institutionen und Verhaltensweisen der privaten, öffentlichen und privatwirtschaftlichen Sektoren in ihrer Funktion als Sparer und Investoren.In einem zweiten Argument werden die Versuche Deutschlands und Japans aufgenommen, ein hybrides Modell zwischen dem marktbasierten und dem bankenbasierten System zu finden, obwohl gestaltender Politik oft nur eine „entweder – oder“ Wahlmöglichkeit zwischen dem ersten, häufig als „liberal“ adressierten, und dem zweiten, dem „nicht – liberalen“ System zugebilligt wird.Im dritten und letzten Argument wird gezeigt, dass Banken sogar in marktbasierten Systemen eine gewichtige, wenn auch im Vergleich zu bankenbasierten Systemen kleinere, Rolle spielen. Die letztendliche Form der Koexistenz von Kapitalmärkten und Banken in Deutschland und Japan hängt von der Kreativität und Anstrengungen der Politiker und der Banken selbst ab. Akteure, die mit der Ausgestaltung der betreffenden Institutionen befasst sind, wird empfohlen ein funktionierendes Bankwesen zu erhalten, das den privaten Haushalten und den KMUs zur Verfügung steht sowie gleichzeitig stabile Finanzmärkte für größere Unternehmen und High–Tech Start–Ups zu fördern.

Table of Contents

1. Introduction

One of the key features of both the German and Japanese postwar political economies is a bank-based financial system (Zysman 1983).[1] Bank-based systems are distinguishable from market-based systems not only by a much higher proportion of bank deposits and loans in total domestic financial assets and liabilities but also by ownership and managerial links between banks and large industrial companies. In the 1980s bank-based systems were widely perceived to be superior to market-based systems in their ability to provide long-term "patient" capital to industry, and many researchers and policy-makers in the US and UK advocated adoption of these systems as a remedy to industrial decline (Jacobs 1991; Porter 1992).[2]

Since the early 1990s, however, the bank-based financial systems in both Japan and Germany have faced serious challenges. First, a general structural trend since the 1970s – the shift of major domestic customers such as non-financial companies, households and the state to market-based forms of finance – appears to have accelerated in the 1990s. Second, macroeconomic developments, including slower worldwide growth and policy-induced demand shocks, have contributed to a bad debt problem; this problem is particularly severe in Japan but is also apparent in Germany. Third, a variety of actors – including some major banks, the US government, and segments of the German and Japanese state apparatus – are actively pursuing "financial reform" aimed at dismantling key institutions supporting the bank-based systems. As reflected in the debate on convergence to a US/UK style market-based financial system, these challenges are so fundamental as to question the future viability of bank-based systems (Gardener and Molyneux 1993; Rybczynski 1988).

This paper assesses the potential paths of development for these bank-based systems and argues that change in the two countries is poorly captured by the "convergence-divergence" dichotomy. Instead, the concepts of path dependency, functional equivalence, and hybridization are more useful tools for understanding the complexity and contingency of processes which rarely (if ever) end in the concrete

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1 The author would like to thank Gregory Jackson, T.J. Pempel, Wolfgang Streeck and Kozo Yamamura for important comments on and suggestions for improvement of earlier drafts of this paper.

2 The precise impact of these features on "real" economic outcomes is still a matter of controversy. However, on balance the evidence seems to show that bank-based systems contributed to the remarkable success of capital-intensive, export-oriented industry in Japan and Germany by allowing more rapid growth (particularly during reconstruction) and by supporting companies during liquidity and demand crises.

realization of ideal typical models. The first point made is that an examination of changes in financial systems should start with an analysis of what are here called the "societal foundations" of bank-based systems. Bank-based systems rest not just on a set of financial regulatory practices but also on the institutions and behavior of the household, corporate and public sectors as savers and investors. A review of these major sectors shows that some but not all of these sectors have shifted preferences to a market-based system. Although Germany and Japan have similar societal foundations, support for a bank-based system has eroded to a somewhat greater degree in Germany.

The second point made in this paper is that, although public policy choices are often presented in terms of a stark dichotomy between "liberal" and "non-liberal" modes of regulation (the former associated with market-based systems, the latter with bank-based systems), in fact both Germany and Japan are struggling to find a successful combination or "hybrid" of the two types of financial regulation. Despite the popular image that market-based systems can simply be created through deregulation, in fact the regulation of financial markets in the US (the benchmark case for liberal systems) is based on an extensive set of rules strictly enforced by a large administrative apparatus with the backing of a strong judicial system. This means that institutions and norms need to be created, not just destroyed, in order to support stable financial markets. Conflicts with existing institutions and their sponsoring interest groups are preprogrammed when liberal institutions are introduced. Although the non-liberal regulatory systems in the two countries were in many ways functionally equivalent (e.g. in suppressing capital markets), German corporatist institutions seem to be better able to coexist with liberal modes of regulation than the Japanese practice of administrative guidance. Not surprisingly, regulatory change has taken the form of a "Big Bang" in Japan versus a (to the general public) obscure set of Financial Market Promotion Laws in Germany.

A third and final point is that banks play important (if diminished) roles even in market-based systems. In the US banks are still the most important providers of financial services to small businesses and lower- and middle-income households; furthermore, they provide "liquidity insurance" in the form of backup lines of credit to large companies. Thus the ultimate form that the coexistence of banks and markets will take in Japan and Germany depends in large part on the creativity and efforts of policymakers and the banks themselves. Those interested in institutional design should focus on how to preserve a viable banking system for SMEs and the household sector while simultaneously promoting stable capital markets for larger companies and high-tech start-ups.

The first section of this paper reviews changes in the societal foundations of bank-based systems in both countries. The second section looks at the reform of financial regulation (narrowly defined). The final section of the paper concludes by examining issues relevant to the future of banks in the two systems.

2. Societal Foundations of Bank-Based Systems

Most accounts of change in financial systems focus on financial regulatory reform narrowly defined. Here, however, I argue that the characteristics of financial systems are a product of both narrow financial regulation and of what I call societal regulation. According to this approach the financial system is viewed as a set of institutions and organizations at the center of the monetary economy which mediate the flow of savings and investment between non-financial sectors of the economy (i.e. the household, non-financial company, and state sectors). Banks and markets thus compete with each other as alternatives for mediating the flow of these funds.

Financial regulations can (and usually do) advantage one alternative over another and therefore play a role in determining which one dominates the financial system. However, non-financial sectors also have a set of demand and supply preferences with regard to the basic characteristics of different types of financial assets (i.e. bank products versus marketable securities). A stable equilibrium is best produced when the bias of financial regulations for either banks or markets is matched by the weight of preferences of the non-financial sectors. The most important characteristics of different financial assets are liquidity, risk, and return, which are (as a broad-brush generalization) higher for market-based than for bank-based forms of finance:

- *Liquidity* is the ease with which investors can buy or sell a financial asset at its "current value." Marketable securities are in principle designed with standardized characteristics in order to have high degrees of liquidity. Securities exchanges are endowed with institutional features in order to promote this liquidity, such as specialized securities houses obligated to accept buy and sell orders in order to assure "orderly markets." Bank loans, on the other hand, have little or no liquidity in the limiting case of a loan or long-term deposit contract between one bank and one customer. These contracts can be prematurely terminated or assigned to another party only through negotiation between the two parties to the contract.
- *Risk* is the probability that the stream of income expected from a financial asset will not be realized, either due to lower profitability of a firm or, in the limiting case, bankruptcy. Company and bankruptcy law defines a hierarchy in the order in which the claims of different kinds of investors should be met in the case of insufficient funds. Stockholders enjoy the last (or residual) claims on income and assets, thus, holders of marketable shares face higher risk than bank lenders.
- *Return* is the expected increase in the value of the original investment made over a specific period of time. Investors as a rule demand higher returns on riskier investments to compensate for extra risk; thus marketable securities must offer a higher return in order to compensate for higher risk.

It is possible to draw up the following generalized preference schedule for the different non-financial sectors with regard to bank- versus market-based finance (see table 1):

Company sector. The non-financial company sector is typically the largest net debtor sector (i.e. largest source of demand for finance) in industrialized economies.

The demand for different kinds of finance varies greatly by type of firm. Due to the large fixed costs of underwriting new securities, market-based finance is much more costly or inaccessible to small and medium-sized enterprises (SMEs) than bank loans. One reason for this is that high fixed costs are involved in new securities issues, which become proportionately larger the smaller the amount of financing involved. A second reason is that large portfolio investors may avoid investing in companies below a certain size, since the costs of information-gathering and monitoring are also fixed and thus render small investments unprofitable. Large firms with high levels of debt also tend to prefer bank-based finance since market-based investors see these firms as too risky for further investment; banks with significant loans to these firms may be forced to make new loans to stave off default on existing loans. Large firms with low levels of debt in contrast prefer market-based systems because of the higher returns they can get by investing in market securities rather than bank deposits. A bank-based system is thus best supported by economies with high proportions of SMEs and of high-debt large firms.

Household sector. The distribution of income and wealth in a society has an impact on the structure of financial systems since different income groups have varying preferences for financial assets (Vitols 1996). High income households prefer market-based finance because of the higher expected return and because their greater ability to absorb short-term market risk. Low income households have little capacity to save, and what they do goes mainly into short-term bank deposits. Middle-income groups have a greater ability to save than low-income groups, but prefer less risky (lower return) assets than high-income groups. Long-term bank deposits and bank bonds have such low-risk moderate-return characteristics. Bank-based systems will therefore be best supported by societies with low levels of inequality (and thus a relatively large middle-income group).

State sector. Government bonds are the easiest type of asset upon which financial markets can be built. Government debt is particularly liquid, since it is highly standardized and issued on a regular schedule according to the budget cycle. Furthermore, the probability of repayment is higher than in the case of private companies due to the power to tax. Since a government debt securities market is thus potentially a great competitor to banks, a low level of public debt is thus more supportive of bank-based systems than a high level of public debt.

Pension Policy. Although not a sector per se, it is particularly important to examine the characteristics of pension policy, since provision for old-age pensions can potentially involve the accumulation of a huge amount of financial assets. The large pension funds typical of pre-funded pension systems are one of the biggest sources of demand for capital market securities. Thus pension systems that emphasize full funding on an individual basis are most supportive of market-based systems. In contrast, pay-as-you-go state systems (which involve little accumulation of financial assets) and company pension systems which reinvest money within the company rather than on financial markets (a book reserve system) are most supportive of bank-based systems. Alternatively, state pension funds that invest mainly in bank bonds or non-securitized assets also support bank-based systems (Jackson and Vitols 1998).

2.1 Financial Asset Preferences in Germany and Japan

Postwar Germany and Japan share many common characteristics with regard to the societal foundations of bank-based systems. Both countries have an industrial structure with a focus on manufacturing and a high concentration of SMEs. For example, companies with less than 500 employees account for 65% and 70% of manufacturing employment in Germany and Japan, respectively, as opposed to about one-third of employment in the US and UK (Acs and Audretsch 1993). In order to “jump-start” their economies in the reconstruction period, key industries were financed through levels of bank debt that could not be provided through capital markets (Calder 1993; Pohl 1973). Both countries have low levels of inequality and high savings levels in comparative terms (including in comparison with the US) (Atkinson, Rainwater, and Smeeding 1995; Avery and Elliehausen 1986). In the first postwar decades both countries had low budget deficits or even surpluses, thus the issuance of government debt was low and the market for such debt insignificant. Finally, pension policy has allowed companies to provide for supplementary pensions through the accumulation of company reserves. Germany has a pay-as-you-go state pension system; Japan's pension system is only partially capitalized and invests to a great extent in the debentures of long-term credit banks and state agencies.

The societal foundations of bank-based systems in both countries have faced similar pressures, when somewhat different in terms of timing and intensity. The pattern of financing for large firms in both countries started to shift in the 1970s as growth slowed; the demand for external finance overall started to decrease, and large firms were also best able to tap cheaper sources of finance than bank loans (e.g. euromarket bond issues) (Campbell and Hamao 1994; Deutsche Bundesbank 1992). Thus large firms that have succeeded in reducing their debt levels have turned into major supporters of market-based finance. High debt companies, in contrast, need the continued support of banks in order to roll over finance; it appears that there are somewhat more of these companies in Japan than in Germany. SMEs in contrast have become even more dependent upon bank finance, since greater competition has eroded profit margins and thus the ability to self-finance investment. High-tech SMEs, which are potentially interested in market finance through an IPO (initial public offering of new securities when a company becomes listed for the first time on a stock market); such SMEs account for a relatively small portion of the company sector in both countries.

A second important change is the shift in patterns of public finance. Whereas public indebtedness in the postwar period was low and could be handled mainly through the banking system, governments in both countries now issue huge amounts of debt. Japan started issuing considerable debt in the mid-1970s in order to provide fiscal stimulus through deficit spending during the oil crisis. Debt issuance has increased very rapidly in the 1990s in order to try to stimulate the post-bubble economy. Germany's public finances held up well through the 1980s but the government started issuing massive amounts of debt in the 1990s in order to help finance unification. The role of the government debt market in undermining control of the banking sector in Japan is well-documented (Hamada and Horiuchi 1987). The German case is not as well documented, but the market for German federal government securities now constitutes the largest single European securities market.

Less change can be seen in the household sector. Increases in inequality and thus in the balance between sectors have remained modest in cross-national comparison. It should be noted however that there appears to be a slow shift among the middle income sectors away from fixed-interest products (such as long-term deposits and bank bonds) toward investment funds. This shift is more pronounced in Germany, where there is greater availability of investment funds (Deutsche Bundesbank 1995).3 This shift represents an indirect support for markets, since these investment funds mainly invest in securitized assets such as stocks and bonds. A sharper movement toward inequality could potentially accelerate this trend of indirect support of markets.

The greatest outstanding public policy issue in both countries at this point is the problematic of pension policy. It is increasingly acknowledged that the aging population and the greater flexibility of labor markets is increasingly straining the existing pension systems (pay-as-you-go state pensions in Germany, incompletely capitalized public pensions in Japan, supplementary pension provision through company reserves in both countries). The considerable problems involved in introducing a fully capitalized system, such as the greater costs involved in the short-term and tax implications, have blocked a move toward such a fully capitalized system. Such a move could potentially represent a major step in the creation of US-style pension funds, which have become the greatest support for the US market-based financial system.

In summary, the biggest shift in preferences toward market-based finance in both countries has occurred among large firms and the public sector; support for bank-based finance among SMEs and households in contrast remains high. Within these broad trends, support for market-based finance appears to be slightly higher in Germany than in Japan due to the lower number of highly-indebted large firms and

3 In Japan there appears to be a slight reversal of this trend during the financial crisis of 1997-1998.

the somewhat greater shift toward investment funds among the household sector in Germany.

3. Freer Markets – And More Rules? The Development of Hybrid Regulatory Forms in Germany and Japan

As discussed in the introduction to this paper, the characteristics of financial systems are dependent on both the societal foundations of these systems (i.e. preferences and behavior of non-financial sectors) and on the norms and institutions that make up financial regulation per se. The last section identified a slight shift in these societal foundations in favor of market systems. In order to asses the degree of change in financial systems, however, it is also necessary to analyze the extent to which financial regulation itself has changed, which is the subject of this section.

3.1 Rationale for Financial Market Regulation

A common view of the liberalization process, largely inspired by neo-classical microeconomic models, equates deregulation with the creation of efficient markets. However, a substantial body of literature has emerged which establishes that this process is considerably more complex, particularly in situations where the standard neoclassical assumptions (i.e. perfect and costless information and a multitude of small price-taking actors) are not realized (Vogel 1996). In such situations new forms of regulation (or "re-regulation") are needed in order to avoid the (re)emergence of dysfunctions the original regulatory systems were designed to address.

One of the strongest cases of deviation from neoclassical assumptions which illustrates the need for re-regulation is the financial system (Dewatripont and Tirole 1994). First, the dependence of asset values on "expectations" of the future development of a multitude of factors makes it extremely difficult to determine the "fair value" of these assets; changes in expectations can thus lead to radical shifts in asset prices. Second, the financial system is characterized by extreme differences between "insiders" and "outsiders" in the quality and speed of access to price-sensitive information. Third, even markets with thousands of investors are typically dominated (at least in the short run) by a small number of large actors. Fourth, the problem of moral hazard is particularly great due to the long-term nature of many investments and thus the ability to "hide" true performance for substantial periods of time. As a result of these four factors, unregulated financial markets are particularly subject to market manipulation and to large swings between speculative bubbles and crashes.

Pre-capitalist societies typically imposed a series of constraints on financial activities such as usury restrictions and the prohibition of the limited liability corporate form. The lifting of these restrictions through the introduction of a laissez-faire attitude by the state to such activity in the nineteenth century was important for the development of financial markets. This development however was accompanied by increasingly severe financial disorders culminating in the Great Depression in the 1930s. The depth of the financial crisis was one of the main factors catalyzing the replacement of laissez-faire with more interventionistic regulatory regimes in the 1930s and 1940s (Forsyth and Notermans 1997; Vitols 2001).

From an ideal-typical point of view there have been two broad alternatives for the establishment of financial regulatory regimes: a liberal regime favoring capital markets and a non-liberal regime favoring banks. The main features of these systems are summarized in table 2. The guiding philosophy of liberal regimes is that investors on capital markets should be free to enter financial contracts and to accept the risks and obligations this entails. The main role of regulation is therefore to reduce information asymmetries and to enable the enforcement of contractual obligations. A level playing field for investors should be created through a set of strictly-enforced rules requiring high levels of transparency and constraining market manipulation and fraud. Banks however should be more strictly regulated because small depositors are less sophisticated and because bank crises are more dangerous for the real economy due to the role of banks in facilitating payment for goods and services. Finally, monetary policy must be oriented to price stability in order to reduce the potential of rapid asset inflation or deflation which often plague markets with "free" price setting.

The second alternative, non-liberal regulation, by way of contrast sees capital markets as the greatest danger to financial system stability (see table 2 again). It therefore imposes a variety of discriminatory restrictions on these markets, particularly on the use of more speculative financial assets (derivatives such as options and futures) and on the practice of short selling.[4] Stability in the banking system is fostered by creating incentives for "responsible" behavior by the leading banks. The main benefit from this regime for smaller investors is supposed to be avoidance of financial loss caused by panics or crashes. A significant proportion of total financial assets are controlled by public or private non-profit (e.g. cooperative)

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4 Through the creation of a leverage effect, derivatives allow investors to profit disproportionately from price changes, but conversely increase the potential of total loss and thus system-threatening bankruptcies on the part of major investors. Short selling involves the selling of borrowed securities with the hope that a price decline will allow for the (profitable) repurchase of these securities at lower cost. It is widely believed that short selling has initiated or exacerbated stock market crashes.

financial institutions. Finally, the ability to suppress inflationary and speculative tendencies through regulation opens up the potential for orienting monetary policy to goals other than price stability, such as low interest rates or low exchange rates to promote rapid economic growth.

Though both the German and Japanese regulatory regimes can be characterized as non-liberal according to this generic classification, the specific features of both regimes vary quite broadly (see table 3). These differences have quite significant consequences for the process of transition to a more liberal regime. Before discussing these differences, however, it is useful to analyze the US, the benchmark case for liberal financial regulation.

3.2 Liberal Financial Regulation in the US

The US, which is widely held to have the most developed capital markets, also has the strongest liberal regulatory system (Seligman 1995). The foundations of this system were laid in the 1930s. The weak system of national banking regulation was substantially strengthened through the 1933 and 1934 Banking Acts. National bank regulators, including the Federal Reserve Board, the Comptroller of the Currency, and the newly-established Federal Deposit Insurance Corporation (FDIC), were given stronger regulatory and enforcement powers. Portions of the 1933 Banking Act (the “Glass-Steagall” provisions) also forbid commercial banks from participating in most capital market activities.

In contrast with the conservative regulation of the banking sector, which aimed to promote stability, capital market regulation emphasized transparency and prevention of market manipulation. The most significant pieces of legislation here were the Securities Act of 1933 and the Securities Exchange Act of 1934. The first regulated the issuance of new securities through establishing a Securities and Exchange Commission (SEC) to oversee markets. It also defined an obligation to disclose truthfully information in prospectuses for new securities offerings. The second authorized the SEC to develop rules for trading in secondary markets. In line with the adversarial legalistic pattern of state regulation (Kagan 1991), the SEC has developed an extensive set of rules and practices regarding conditions under which securities can be issued, minimum information requirements, fair determination of market prices, exercise of shareholder voting rights and communication with management, abuse of dominant market position and insider information, and takeover rules.

The Federal Reserve Board ("the Fed") has long been seen as one of the most independent central banks. Although key members of the board are appointed by the

President (with the approval of the Senate), there are no ex-officio members of government on the board, nor is the government authorized to send observers to board meetings. The Fed has jealously guarded its rights of independent policy-making on interest rates and (with the exception of the 1970s) has put its primary emphasis on price stability.

3.3 Corporatist Regulation of the German Universal Bank System

Prior to the 1930s German financial system regulation could be described as laissez-faire (Born 1967). In response to the Banking Crisis of 1931, which was part of the worldwide reaction to the post-1929 stock market crash difficulties in the US, a number of large banks were effectively nationalized and a corporatist regulatory regime established.[5] Key features of this corporatist regime survived the wartime economy or were reestablished in the reconstruction period after World War II. These included the corporatist regulation of interest rates on deposits and fees on basic services, the authorization of capital adequacy and liquidity requirements to be developed in consultation with the bank associations, definition of auditing responsibilities by associations of public savings banks and cooperatives, and constraints on entry.[6] Due to fears of increasing long-term interest rates a corporatist bond committee dominated by the leading securities issuers (joint-stock banks, and the national banks for the credit cooperative and municipal savings bank sector) was established in the reconstruction period to control access to capital markets (Büschgen 1983).

Although the postwar Adenauer government had a nominal commitment to liberal capital markets, in fact public policy discouraged their development as a source of long-term capital for industry. The tax system favored public bonds (particularly for housing and infrastructure) over industrial bonds. The corporatist bond committee also gave clear priority to public and bank bonds over industrial bonds in the queue for access to capital markets (Rosen 1997). Double taxation of equities (corporation tax plus individual income tax) stunted the development of equities markets. As a result external finance for industry was almost entirely provided by bank loans rather than equity or bond issues.

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5 Corporatism involves "self-regulation" through associations. In contrast with voluntary regulation, however, the state provides a variety of incentives for association membership and also recognize association decisions as binding (Schmitter and Streeck 1985).

6 For example, new credit cooperatives had to receive approval from the appropriate regional cooperative association before starting business.

A further defining characteristic of German financial regulation is the degree to which the financial system is composed of not-for-profit institutions (Deeg 1992). The public banking sector, composed of municipal savings banks on the city and county level and regional banks at the Länder level, accounts for about half of all banking system assets. By law these banks are charged with helping lower income groups save and with promoting regional development. Somewhat less than 20 percent of banking system assets are accounted for by the credit cooperative sector, whose goal is to support small businesses and professionals. A final characteristic of the postwar German financial system was the orientation of monetary policy toward a low exchange rate to promote exports.

With the exception of monetary policy, which shifted to a price-stability orientation in the early 1970s, this financial regulatory regime survived intact into the 1990s. A number of smaller reforms with a "deregulatory" thrust undertaken by the conservative-liberal government in the 1980s had minor effects. These included removing the securities transaction tax, creating an "over-the-counter" (OTC) stock market segment, and authorizing a “junior joint-stock company” legal form with looser transparency requirements. Pressure from the US to establish a German equivalent of the Securities Exchange Commission was resisted.

In the 1990s, however, this pattern of minor changes was reversed and a number of important financial reforms were introduced (Lütz 1996). The most important reason for this change was a shift in the interests of the large private banks (Großbanken). Despite formal designation as "universal banks", the dominant self-image of large private banks throughout the postwar period was that of deposit takers and credit providers (Gall et al. 1995). Significantly, people in top management positions generally came from corporate lending departments. These banks, particularly the Deutsche Bank and Dresdner Bank, began to model themselves after top US investment banks and started the difficult process of shifting their focus away from commercial banking activities. Shortly before his murder by the Red Army Faction in 1990, the head of Deutsche Bank (Alfred Herrhausen) stated that his bank had a ten-year window of opportunity to change or perish. In the past decade, activities by German banks in the major international financial centers were expanded, in large part through acquiring British and US investment banks. These banks also saw the need to have a strong domestic base in order to become "global players" in investment banking. Reform of the domestic financial system along US lines was seen as a crucial step to strengthening this base.

True to the corporatist pattern, the national association of private banks (Bundesverband deutscher Banken) took the lead in making policy proposals. The government's role was mainly one of structuring the legislative process (including preliminary expert hearings, coalition working groups, and parliamentary hearings), leading the negotiating process, and the technical formulation of drafts and final versions of various laws. The most important of these in the 1990s were the Second and Third Financial Markets Promotion Acts and the Law on Transparency and Control in Corporations (KonTraG).

The Second Financial Market Promotion Law (1994) has been the most important step toward establishing US-style regulation of capital markets. It established an independent regulatory agency (Bundesaufsichtsamt für Wertpapierhandel) for policing financial markets modeled on the US Securities Exchange Commission. It also defined a set of rules for dealing with “insider” information with potential impact on securities prices. Significantly, the US had been pressing for the passage of such legislation for over ten years without effect (Lütz 1996). The changed attitude of the large banks toward such regulation (instead of the traditional corporatist policing of “responsible behavior”) is a key factor explaining the passage of this legislation. This Act also authorized money market funds after the Bundesbank dropped its long-standing opposition, and also broadened the available legal forms for venture capital funds.

The Third Financial Markets Promotion Act (1997) increased the permissible form of mutual funds, including the establishment of a special private retirement savings option (Pensionssondervermögen), which can be organized as a mutual fund. The large banks were especially keen on increasing their mutual fund activities, a lucrative new area of business in Germany. An important change between the initial draft and final versions of this legislation was the striking of tax benefits for the private retirement savings plans. This provision was struck out due to the opposition of the life insurance companies (who feared the loss of business to bank-affiliated or independent mutual funds) and the budget division of the Finance Ministry. This Act also eased listing and reporting requirements for companies and made some changes regarding venture capital.

While not falling under the “narrow” definition of financial regulation, the Law on Transparency and Control in Corporations (KonTraG) of 1997 was important for the development of financial markets (Ziegler 2000). Unlike the Financial Markets Promotion Acts, KonTraG was primarily an initiative of the governing coalition. The coalition felt obligated to do something in response to a number of spectacular failures of control through supervisory boards (failure of Metallgesellschaft, Bremer Vulkan and Balsam, plus the Deutsche Bank’s large loan exposure to the bankrupt Schneider property development group). The most significant provisions of KonTraG, however, which authorize stock option plans and the buyback of shares, were inserted at the suggestion of a coalition of the industry and banking associations. KonTraG was held up for about a year because unions opposed a provision reducing the size of supervisory boards (and thus the number of union representatives). The relatively small Christian Democratic unions were particularly opposed to this. Local and regional governments also opposed provisions that would reduce their influence over companies partially in their ownership (e.g. abolishment of multiple voting rights on certain categories of stock). KonTraG was passed when these provisions were changed and thus opposition was dropped.

Although these changes have been important Germany is still far removed from a US-style "adversarial legalistic" regulatory system. Firstly, the policy-making process remains highly corporatistic and consensual. The banking associations remain central to the process of policy-making and a major association can block change. Secondly, the associations retain their role in monitoring and the enforcement of rules. Thirdly, the new securities regulatory agency has proven extremely weak in the absence of the juridical system needed to support a rule-based system.[7] The financial regulatory system evolving in Germany is a hybrid of traditional corporatist elements and US-style liberal regulatory institutions.

3.4 Japan: State-Driven Change or the Rise and Fall of Administrative Guidance?

As in the US and Germany, the financial regulatory system in Japan prior to the 1930s could be characterized as laissez-faire (Ueda 1994; Vitols 2001). In the context of the Banking Crisis of 1927, a deepening of the financial crisis in the 1930s and the mobilization for war, a regulatory system emphasizing stability and the channeling of finance for the achievement of public goals was built up. Despite efforts by the US occupation authorities to "democratize" the Japanese financial system, many features of this regulatory system survived the reconstruction period or were reestablished in the late 1940s (see table 3).

At the core of this regime was a regulatory relationship between state and financial institutions characterized as administrative guidance, which involves the exercise of bureaucratic power without express legal basis. The power basis of administrative guidance is the requirement that permission be obtained from the state in the form of licenses in order to undertake a wide variety of activities. State

7 One example which illustrates the continued occurance of market manipulation in Germany that would be unthinkable in the US is the second tranche of issuance of shares to the public by Deutsche Telekom, the German public telecommunications company. The pricing of this second tranche was to be determined by the closing price of the shares already circulating on the Friday prior to the Monday issuance of these new shares. A consortia of two dozen banks had agreed to take over a major portion of this second tranche of shares for later sale to the general investing public. In the last half hour of trading on the Friday many of the consortia banks put unlimited sell orders for the shares on the market, which had the effect of depressing share price by 13%. As a result of this action the proceeds for the government of the second tranche were about 2 billion DM less than planned. Government regulators claimed that they lacked the legal tools needed to prosecute such a brazen example of market manipulation.

bureaucrats enjoy significant discretionary power since the criteria for the granting of these licenses are quite vague and regulated parties are dependent upon further licenses in the future to stay in business (Sohn 1998).

In the financial system the basis of administrative guidance was created by the Banking Act of 1927, which was passed in response to the Banking Crisis of 1927 and granted sweeping but vague regulatory powers to the state (Adams 1964; Nakamura 1998). However, these powers were first utilized to a great extent in conjunction with military mobilization in the mid-1930s when an effective system of close bank regulation under the Ministry of Finance was built up. The establishment of an extensive licensing system reinforced government influence by controlling entry to the financial system and by making existing institutions dependent upon government approval for many actions such as the establishment of new branches. The encouragement of oligopolization in the 1930s also helped support administrative guidance by reducing the number of subjects of regulation. After World War II administrative guidance developed into an extensive system of informal relations between regulators and financial institutions often involving unwritten instructions on bank lending and branching policy, the acquisition of smaller financial institutions, and many other aspects of financial policy. Administrative guidance was the glue of the so-called convoy system, by which all ships (in this case financial institutions) would be protected (from bankruptcies) and move at the same pace (by observing all guidance).

In addition to the informal regulatory powers created by administrative guidance there were a number of formal restrictions and informal practices aimed at stunting capital market growth. One was stringent restrictions on the issuance of corporate bonds, such as a stringent collateral requirements. Another was the practice of issuing new shares at par value rather than market value. This practice discourages using secondary issues (i.e. issuance of additional shares) for raising capital, since the proceeds of new issues would be limited for companies whose shares have appreciated quite substantially above original par value. Finally, a Bond Committee composed of representatives of the state and leading financial institutions regulated access to capital markets through the approval of the size and timing of new bond issues. As a result of all of these restrictions, capital markets proved to be a rarely used financing mechanism for industry and almost all external finance during the "high growth" era was raised in the form of bank loans.

Flanking administrative guidance was an extensive set of non-profit financial institutions established in order to achieve a variety of public goals. The most famous of these is the Postal Savings System, which due to the convenience of an extensive set of branches and tax advantages is the preferred savings vehicle for many households (Calder 1993). Through various types of deposits and insurance policies, the Postal Savings System controls a huge amount of financial assets. These savings are channeled into the real economy through the Fiscal Investment and Loan

Program (FILP) and through buying up the debentures of the long-term credit banks. In addition to other specialized public financial institutions (e.g. for housing finance) an extensive set of non-profit credit cooperatives supports the needs of smaller businesses and agriculture.

Due to the various mechanisms available to control the expansion and allocation of credit (administrative guidance and direct control over public financial institutions) monetary policy was to a great extent free of the constraint of controlling price inflation. Throughout the "high growth" period the Bank of Japan (under the guidance of the Ministry of Finance) set an artificially low interest rate to encourage industrial investment. Though the efficacy of targeting is still controversial, there is general agreement that the low interest rate policy facilitated a massive transfer of capital from the household to the corporate sectors (Hamanda and Horiuchi 1987).

In contrast to the German case the first element of the non-liberal regulatory system to weaken was conservative fiscal policy. In response to the 1973 oil shock the government initiated heavy deficit-spending and had to massively increase its issuance of bonds. The increase in bonds was so great that the normal sales channel (purchase by banks) was overloaded and a market had to be created to absorb these securities. In contrast with the stock market, where shares could be placed largely with friendly keiretsu members, this government debt market slowly began to function as a true market in terms of liquidity, price-setting and return in order to induce purchase of government bonds (Yamamura 1985).

A second part of the postwar system that had to be dismantled was the system of regulated and artificially low interest rates. One reason for this was the previously mentioned creation of the government bond market. The availability of higher interest rates on this market leads to a draining of assets from portions of the financial system where rates are "controlled". This was a major incentive for the gradual deregulation of interest rates on bank deposits. A second reason for this shift in interest rate policy was the need to orient monetary policy toward influence the exchange rate after the abandonment of fixed interest rates and the move to "floating." Japan had rapidly shifted from net debtor to net creditor status and this was putting increasing strain on the exchange rate.

Another significant move toward deregulation was taken with a package of financial system reforms passed in 1992. These reforms, which modified 16 different laws, took a major step toward loosening the system of strict segmentation between commercial banking, securities and trust activities. Financial institutions in one of these segments were allowed to enter other segments through establishing new subsidiaries or purchasing existing (in practice mainly troubled) firms (Rosenbluth 1989).

Although these steps – the creation of a liquid government bond market, interest rate deregulation, and the weakening of segmentation requirements – represented significant deregulatory moves, the basic structure of administrative guidance remained intact through the first half of the 1990s. Though administrative guidance had been weakened somewhat through interest rate deregulation and the abolishment of "window guidance" (determination of acceptable increases in lending) at the Bank of Japan, the 1992 package of reforms in fact strengthened the powers of the Ministry of Finance over the financial system. Under the rationale of controlling the pace of change in the financial system, financial institutions had to obtain a license from the MoF in order to enter a new financial segment. This created a new and powerful means of influence reinforcing administrative guidance. Although a regulatory agency (the Securities and Exchange Surveillance Commission) was established to police capital markets – ostensibly on the model of the US SEC – in fact this agency was effectively put under the control of MoF (e.g. it had no independent powers to prosecute violations of securities laws).

The system of administrative guidance itself was fundamentally challenged for the first time in 1996 by Prime Minister Hashimoto's announcement of wide-reaching reforms in government practices and in financial regulation (the latter characterized as "Big Bang"). A series of scandals implicating the MoF, which turned out to be quite costly for the taxpayers, helped create public support for fundamental change. The unfolding of the Asian financial crisis in 1997 and 1998, which brought already-weak Japanese banks to the brink of insolvency due to their heavy lending exposure to East Asian countries, further created an atmosphere of support for fundamental reform.

The Big Bang reforms encompass a series of important deregulatory measures, including the deregulation of brokerage commissions and the authorization of financial holding companies to further facilitate mutual entry of market segments. Probably the most fundamental change, however, was the attempt to establish a set of regulatory agencies truly independent of the MoF and operating in a transparent, rule-based manner. If successful, the creation of such strong and effective independent regulatory agencies would represent a major step in establishing a liberal financial regulatory regime in Japan.

One such move was the transformation of the Bank of Japan from a dependent arm of the MoF to an independent central bank. The new Bank of Japan law modified the composition of the monetary policy board by excluding ex-officio government members.[8] The policy board is also required under the new law to publish the transcripts of its meetings to improve the transparency of its decision-making. The new independence of the BoJ can be seen in public defiance of MoF pressure;

8 Although these government members formally had no voting rights, in fact they were held to exercise considerable influence over board decisions.

against the MoF's wishes, the BoJ refused to directly purchase government bonds to fund fiscal stimulus packages, to sterilize exchange rate interventions in late 1999 and early 2000, or to continue the "zero interest rate" policy by increasing interest rates in August 2000.

A second major step toward creating a liberal regulatory regime was the establishment of the Financial Supervision Agency (FSA) for the regulation of banks and brokers. The criticism leading to this measure was that the MoF had too much of a conflict of interest as both "coach" and "umpire" of financial institutions. Instead, these functions should be clearly separated between a MoF with reduced powers and a truly independent FSA. Similar to the case of the 1992 creation of the SESC, the MoF attempted to subvert this intention for independence through controlling the staffing of the FSA and seeing that the new agency be provided with inadequate resources. Insufficient resources and permanent rotation of staff between the MoF and FSA would substantially weaken the effective independence of the FSE. In part due to public pressure however the LDP blocked this attempt by stipulating that FSA staff would not be allowed to return to the MoF.[9]

A third important liberal measure is the introduction of clear rules and improved transparency for the financial system. One aspect of this was the replacement of the licensing system with a registration requirement for the establishment of subsidiaries in new financial segments. The definition of a set of requirements which grant a right to entry once fulfilled would substantially reduce the arbitrary decision-making power of MoF. A second aspect was the introduction of Prompt Corrective Action (PCA) which would automatically trigger intervention by the regulatory agency when the capital of a specific bank would fall below the 8% level. The intensity of intervention would be determined by how far bank capital had been eroded. The replacement of "mark-to-cost" with "mark-to-market" accounting was also intended to give a truer picture of a bank's actual financial situation, since the value of assets such as stocks may vary quite substantially from purchase price.

The severity of the banking system's bad loan situation, however, has undermined an already difficult process of transition to a liberal regulatory regime. The effective bankruptcy of all of the city banks except for the Bank of Tokyo-Mitsubishi necessitated the injection of huge amounts of public funds in order to recapitalize these banks. The technical expertise and power of the MoF was needed in order to accomplish this *de facto* nationalization of most of the largest banks and to help develop realistic restructuring plans for restoring profitability. The strict implementation of Prompt Corrective Action according to the original intentions would also effectively shut down other segments of the banking system, and the government has admitted that a rule-based approach to regulation must be modified

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9 As anecdotal evidence in support of the independence of the FSA, interview partners indicated that whereas MoF officials would exchange business cards with bank managers at meetings, FSA officials would point to their official badges.

and watered down in order to avoid a major disruption in the financial system. The difficulties in solving the bad loan situation and in restoring profitability to the banking system is thus likely to continue the current uneasy co-existence of the traditional system of administrative regulation and the nascent liberal regulatory system for the foreseeable future.

3.5 Comparison of Reform in Germany and Japan

When comparing financial reform in Germany and Japan one is struck by differences in the drivers of change and by the greater compatibility of corporatism than administrative guidance with a liberal regulatory regime. In Germany reform has been driven for the most part by the large banks, who desire to create a "home base" supportive of global player investment banks on the US model. While some Japanese banks have also been interested in entry into other domestic segments, such as securities underwriting, their enthusiasm for reform has been tempered by concerns of international competitiveness and the bad loan situation. These concerns are likely to continue and thus moderate support for a liberal regime from an important potential supporter of liberal reform, which is especially important given the vagaries of political parties.

Secondly, an important part of corporatism in the German financial system was the determination of clear rules, such as quantitative banking standards for liquidity and capital adequacy. A gradual and partial shift of regulatory authority to liberal agencies is thus easier to conceive of in the case of Germany’s corporatism than in Japan's administrative regulation. Not surprisingly, attempts at financial reform in Japan have taken the form of a “Big Bang” package of changes receiving widespread popular attention, whereas financial form in Germany has been implemented through a series of legislative acts scarcely noticed by the public at large.

4. On the Future of Bank-Based Systems

In both Germany and Japan the importance of financial markets has increased at the expense of banks in the 1990s. The main contributors to this process have been structural trends, particularly the large-scale issuance of government debt and the decreasing demand of large firms for bank loans, and regulatory changes in the form of both deregulation and the creation of liberal regulatory institutions. The key questions are: how far will these processes go, and what role will banks play in the future in these two countries? Particularly important is the issue of whether banks will be capable of supporting their "natural" constituents, i.e. SMEs and low- and middle-income households.

Since it is difficult if not impossible to imagine turning back the institutional clock to the heyday of bank-based systems a few decades ago, two major scenarios are conceivable. The first would involve convergence to the US market-based model. Structural prerequisites for this scenario – in order to reduce the importance of the "natural" customers of banks – would be a major shrinkage of the SME sector, a serious increase in inequality, maintenance of high public budget deficits, and the introduction of a capitalized pension system. Regulatory prerequisites would be a major strengthening of the new liberal regulatory agencies and a corresponding weakening of corporatist institutions in Germany and administrative guidance in Japan. Privatization of the public savings banks in Germany and a major consolidation in the banking sectors in both countries would also be an important support for this process.

A more likely outcome of the process, however, is a growing dichotomy between domestically- and internationally-oriented segments of the financial system and a continued uneasy coexistence between liberal and non-liberal regulatory modes. This scenario is more apparent in Germany, where the major banks are explicitly pursuing the goal of becoming global players in the investment banking area and have pulled back from servicing SMEs and lower-income households. These banks have also been the most important supporters of the introduction of liberal regulatory institutions on the Frankfurt stock exchange. At the same time, the public savings banks have been able to fight off attempts at privatization, have retained a corporatist form of regulation, and have introduced a broader set of financial services for SMEs and an expanded array of investment funds for their household customers.

The Japanese case is more complex but this second scenario is also arguably the most likely outcome. The potential for creating global players at this point appears to be much smaller and thus support for full-blown liberal financial markets in Japan is weaker. The seriousness of the bad debt situation also means that the need for heavy administrative guidance to support both troubled financial institutions and non-financial firms will persist into the medium-term. Nevertheless the potential for a more liberal, internationally-oriented subsector of the financial system remains, and could increase with substantial progress in clearing up the bad debt situation. Support for this subsector would be provided by the continuing core of low-debt, internationally-competitive companies, Japanese financial institutions in alliances or partially owned by foreign financial institutions, and a private, capitalized pension system. The realization of this second scenario would amount to the achievement of coexistence of both bank-based and market-based finance within the same financial system and in the context of weaker administrative guidance.

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Table 1:
PREFERENCES OF NON-FINANCIAL SECTORS FOR BANK- VERSUS MARKET-BASED FINANCE

Non-Financial Sector	Subsector	Preference for: Banks	Markets
Company Sector	SMEs (Traditional)	+	
	SMEs (High Tech)		+
	Large Firms (High Debt)	+	
	Large Firms (Low Debt)		+
Household Sector	High Income		+
	Middle Income	+	
	Low Income	+	
Pension Policy	Pay-As-You-Go	+	
	Company Reserves	+	
	Capitalized Systems		+

Table 2:
KEY CHARACTERISTICS OF ALTERNATIVE FINANCIAL REGULATORY REGIMES

Regime Characteristics:	Liberal Markt-Based Regimes	Nonliberal Bank-Based Regimes
Most Strictly Regulated Sector	Banks	Capital Markets
Constraints on Large Investors	Rule-Based	Incentives for "Responsible Behavior"
Advantages for Smaller Investors	Transparency	Stability
Orientation of Financial Institutions	Predominantly For-Profit	Mix of For-Profit and Nonprofit
Monetary Policy	Stability-Oriented to Avoid Asset Inflation	Potential for Pursuit of Developmentalist Goals

Table 3:
KEY CHARACTERISTICS OF THE POSTWAR GERMAN AND JAPANESE NON-LIBERAL FINANCIAL REGULATORY REGIMES

	Germany	Japan
Variant of Non-Liberal Regulatory Form	Corporatism	Administrative Guidance
Discriminatory Restrictions and Rationed Access to Capital Markets	Bond Committee	Bond Committee
Not-for-Profit Financial Institutions	Public Savings and Regional Banks Credit Cooperatives	Special-Purpose Public Banks Cooperative Banks
Goal of Public Institutions	Support of Social Market Economy	Developmentalism
Monetary Policy Orientation	Low D-Mark Exchange Rate	Low Interest Rates