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This series was developed by a group of economists and bankers concerned with the current state of affairs in the international monetary field. It seeks to address the key issues and problems confronting the world economy. These issues range from the growth and structure of the Eurocurrency market, which perhaps represents the most astonishing phenomenon in the modern world of finance, to the awesome expansion of Japanese financial power on both domestic and international fronts. The central concern of the series is the still unresolved issue of how to control international monetary growth and how to resolve the problems related to foreign debt faced by both the international banking community and debtor nations. Another related concern is the resurgence of the protectionism which threatens to aggravate some of the most pressing international economic problems, specifically those pertaining to debt and trade imbalances. Finally, it should be noted that the emerging question of how Eastern Europe will be incorporated into the international banking community will be a focus of future volumes in the series.

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Protectionism and International Banking

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MACMILLAN

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within the European Community by 1992, will remove many of these restraints and should lead to more efficient and internationally competitive domestic banking markets throughout the Community.

Turning back to the international banking market, the important question asked by Aliber is what determines the nationalities of banks which provide the services in this competitive market. I agree with him that the cost of capital faced by banks of different nationalities is a key determinant. The cost of capital will in turn depend on the capital requirements imposed by national supervisors and also on the differing costs of raising capital in various markets. Both factors have favoured the emergence of Japanese banks as the largest national grouping in international banking markets in recent years. Not only have the capital requirements imposed by Japanese regulators been lower than in many other countries, but also the high price–earnings ratio of Japanese equity suggests that the actual cost of raising capital may have been lower there than in other countries.

The rise in Japanese banks' share in the international market has been mirrored through the 1980s by a declining share of US banks – at least as regards their on-balance sheet business. The cost of raising new capital, and the particular nature of US capital adequacy requirements, led major US banks to concentrate on building up the earnings from off-balance sheet business during this period. This has led to the development of many new products, and customers with access to these products have benefited from the more efficient financial intermediation and hedging which is now available; these developments have not, however, been without some risk. The strong influence which regulatory differences can be seen to have on the structure of international banking emphasises the need for the convergence of international regulatory standards which is now being put in place.

The share of international banking business transacted in London has been stable at around one-quarter for several years. The proportion of international capital market activity taking place in London is much higher. The United Kingdom has had an open-door policy to most aspects of international financial services and, even though much of the business is in the hands of foreign-owned institutions, has benefited from the direct and indirect employment of labour and other resources which it entails. In addition, British customers have easier access to these services than would be the case if they were produced elsewhere.

Much has been written on the origins of the various Euromarkets in London, but they owe their existence in part to the fact that various regulators are willing to permit the institutions they supervise to conduct offshore various types of business which they are not allowed to do at home. A recent addition to the well-established Eurocurrency deposits and Eurobond markets has been a huge growth in the secondary trading of foreign equities and foreign government bonds in London. This growth follows radical changes to the structure of the London Stock Exchange, which have reduced the costs of secondary trading in London and greatly enhanced the liquidity of the markets. In part, these changes in London were a response to the fact that the Stock Exchange had been losing business as a result of its minimum commission rules and other factors. The Paris Bourse is in turn to undergo a similar liberalisation. It is encouraging that international competitive pressures are breaking down domestic barriers to competition, and so extending the benefits of more efficient financial intermediation to a wider range of customers.

It may be that the protectionist threat, about which we have heard much in this conference, is not as great in financial services as in many other industries – though there are certainly some areas of activity, such as the lead-management of securities issues, where aspiring foreign entrants continue to find it surprisingly difficult to establish themselves in other countries. Central banks, too, may be tempted to support the maintenance of various restrictive practices in national markets, for often the resulting segmentation of markets, the smaller number of firms active in those markets, and the greater relative importance of domestic financial institutions, will make monetary control seem more easy. But the monetary authorities' wish for an easy life must be balanced against the benefits to be gained from more efficient financial intermediation. More competitive financial markets may well be a constraint on the behaviour of central banks and governments, but this constraint will tend to require them to follow sounder policies than might otherwise be the case.

Giuseppe Tullio

Professor Aliber's paper discusses the way competition and regulation influence the structure and size of domestic banking industries and of the offshore markets. It contains a lot of cross-country information on the concentration in banking, and several interesting conclusions. The paper is timely, considering the programme of liberalisation of financial flows and of the right of establishment of banks which the countries

of the European Community are in the process of implementing. Of particular importance for the structure of the European banking systems is the introduction by 1992 of the freedom of establishment of banking and financial firms, under the principle of 'mutual recognition of prudential rules'. This implies that a German bank opening a branch in Italy will be subject to German prudential regulation and not to the Italian one.

There is another reason to single out the European Community when discussing the effect of liberalisation of the capital flows on the structure of banking systems. Two of the main objectives of the EMS (European Monetary System) were to avoid misalignment of exchange rates and to co-ordinate monetary policy. On both accounts the EMS has been very successful. Both the avoidance of misalignment and the co-ordination of monetary policies are preconditions for the achievement of a truly integrated capital market. Hence among EMS countries there is a much better chance to achieve greater liberalisation and to harmonise prudential rules in banking than in a broader context.

Be that as it may, these changes will inject a large degree of competition into the banking system of our countries, particularly in those countries where protection and regulation have been highest so far. At the same time large profit margins will open up for the most competitive banks and most likely major changes in the size and structure of the banking system will occur in many member countries. Professor Aliber's paper supplies us with a useful framework to analyse the changes that may occur. As far as Italy is concerned, I consider these likely structural changes as important as the restructuring of industrial firms which has occurred in the first half of the 1980s, with far-reaching consequences for welfare, income distribution and the framework of monetary policy.

In my comments, I shall summarise Aliber's main conclusions, spending proportionately more time on one conclusion about which I have some reservations. The first question Aliber's paper seeks to answer is: Why are the banking systems of some countries so concentrated (Switzerland, Canada, the United Kingdom), while some others are much less concentrated and have a much larger number of banks compared to their size (the United States, Japan, Italy)? He believes that regulation and protection play a major role in explaining these differences. In less regulated systems, banks can exploit economies of scale, they become larger and concentration increases. Another corollary of his analysis is that the larger the amount of regulation, the smaller the size of the banking system, because regulation and protection increase the cost of banking services. I am in full agreement with these conclusions.

Professor Niehans observed that, to the extent that less regulation leads to less stability of the banking system, less regulation does not necessarily lead to larger banking systems. While acknowledging that there is in general a positive relationship between regulation and stability, I feel that regulation and protection in many southern European countries are so high that they can be reduced without significantly affecting the stability of the banking system. Hence Aliber's conclusion that less regulation would lead to a larger banking system probably still holds for southern European countries.

On the relationship between protection and regulation he advances the hypothesis that they may be orthogonal (substitutes): countries that possess the highest degree of regulation have also the least amount of protection. While this may be true for the United States, I feel that in Japan and Italy regulation and protection are not orthogonal, but rather complementary.

The second question that Aliber's paper poses is: Why are some banking systems so much more international than others? There are two ways to look at the degree of 'internationalisation' of a banking system. The first is to look at 'penetration' of foreign banks, for example the share of assets owned by foreign banks as a proportion of total assets of the banking system. This share increased in the United Kingdom from 6.7 per cent in December 1960 to 62.6 per cent in June 1985. In Germany it increased from 0.5 per cent to 2.4 per cent during the same period.

The second way is to look at the amount of international business conducted by banks located in one country. For instance, the amount of cross-border and cross-currency transactions carried out by banks located in the United Kingdom as a percentage of total lending increased from 14.5 per cent in 1963 to 73.2 per cent in 1983. In Germany it increased from 7.2 per cent in 1975 to 7.4 in 1983.

Taking up the degree of penetration first, Aliber advances three general explanations for penetration possibly being lower in some countries:

1. high regulation and protection of domestic banking systems;
2. large economies of scale in domestic banking which are already exploited by a few large banks;
3. high competition and insufficient profit margins to be exploited by potential entrants.

I agree with Lionel Price that cultural protectionism, long-standing bank–customer relationships, the unavailability of sufficient information and the insufficiency of deposit insurance may be very important too. For instance, in the United States the availability of good credit rating of firms had contributed to foreign penetration. I think the data reported above are also not homogeneous across countries. German ratios are biased downwards by the presence in German banking statistics of a large number of small financial intermediaries.

As to the different amount of cross-border, cross-currency transactions carried out by German and UK banks, which Aliber does not explain, the following explanations could be advanced:

1. the data are not homogeneous across countries and the German ratios are biased downwards;
2. the largest German banks conduct much of their international business from branches located outside Germany, mainly in Luxembourg;
3. the stability of interest rates and of inflation in Germany may have led to a smaller incentive for German savers and industrial firms to diversify into foreign currencies.

Professor Aliber moves on to the analysis of the offshore market. He asks why the banks with headquarters in some countries are over-represented in this market. In December 1983, US banks possessed 29.5 per cent of international assets in the offshore market, while Japanese banks possessed 21 per cent. By September 1987 the share of US banks had fallen to about 17 per cent, while the share of Japanese banks had increased to about 37 per cent. The explanation he offers is that the cost of capital is lower in Japan and the United States than in other countries. No figures about the cost of capital in the various countries are supplied to support this hypothesis.

Be that as it may, I have several reservations about this explanation. First, considering the degree of integration of capital and share markets, at least the large international banks with headquarters in high cost of capital countries could raise capital in low cost countries. Integration of share markets guarantees that shares prices of the same bank quoted on different stock markets are equalised across countries, once different monetary units and arbitrage costs are taken into account. The cost of capital to the bank is a weighted average of the domestic and the foreign cost of capital. Therefore, if the share of the banks' capitalisation in a foreign stock market becomes large, the

foreign cost of capital will exert a significant influence on the total cost of capital to the bank. This would undermine Aliber's explanation.

Second, in my opinion, protection and regulation play an important role in explaining why banks with headquarters in some countries are under-represented in the market. The Italian experience is interesting in this regard. It was very difficult before 1981 for Italian banks to obtain permission to open branches abroad. Before then most branches of Italian banks abroad were in former African colonies. Changes in legislation occurred in 1980/1, when rules were established regarding the supervision of foreign branches. After these legal changes, there was an increase in the presence of Italian banks abroad. As for Germany, I have already indicated that the low variability of interest rates and inflation has reduced the incentive for German residents to diversify into foreign currencies.

Third, I believe that, for the United States, the role of the dollar as reserve currency was of major relevance in explaining why US banks are so strongly represented in the offshore market. Firms all over the world keep transaction balances in US dollars and central banks have to keep international reserves in US dollars. US banks had a comparative advantage in offering dollar deposits; when they decided to move closer to their foreign customers, the offshore markets were born.

Fourth, for Japan, in the course of the 1970s, the excess domestic saving generated was increasingly looking for an outlet abroad and for diversification. In addition exchange rate instability led to large foreign direct investments by Japanese multinational companies. Japanese banks therefore had an incentive to move into the offshore markets to service Japanese multinational companies that were moving abroad and to place the excess international savings that needed a foreign outlet. To sum up, Aliber's hypothesis is not supported by empirical evidence and I am convinced that the historical factors I have mentioned are of major importance in explaining why some countries' banks are over- or under-represented in the offshore markets.

Let me conclude my comments on Professor Aliber's paper with some considerations on the desirable balance between competition and regulation. Banks sell a product that is different from cars. The experience of the 1930s has shown how easily bank panic can occur in the face of external shocks when banks are unregulated. Governments have created a more stable banking system by introducing a lender of last resort function, capital requirements and reserve requirements ratios and by restricting bank portfolios. Unregulated banking allows exploitation of larger economies of scale, a more efficient and, proba-

bly, a larger banking system, but a less stable one in the face of external shocks.

This is not to say that the greater competition which will be injected into our banking systems by capital flow liberalisation and by the free establishment of banking firms is a bad thing. On the contrary, it is a good thing, especially for countries where banks have been highly protected and regulated. I feel, however, that we should be careful not to move towards a too highly unregulated banking system and not to let this process of capital liberalisation and greater freedom of establishment become a way to circumvent prudential regulation.