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In this article, the authors examine some effects of economic internationalization on state structures, especially in regard to the distribution of power and authority within federalist systems. Using an institutional rational choice model, they analyze changes in financial regulation and market structures in Germany and the United States. The focus is on the financial realm because of its high degree of internationalization and because, in both countries, financial markets and regulation have historically exhibited federalist traits. The findings indicate that internationalization has led to significant convergence in financial market structures and regulation across the two countries and that in each case this convergence has been accompanied by centralization of financial regulatory authority. Although both the German type of cooperative federalism and the U.S. model of competitive federalism proved to be vulnerable to the growing international pressures, the two countries took different paths of change that reflected differences in domestic institutions. Thus, the authors conclude that convergence is, and will likely remain, of a limited nature.

INTERNATIONALIZATION AND FINANCIAL FEDERALISM The United States and Germany at the Crossroads?

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The financial sector is probably the most oft-cited example of the growing internationalization of economic and political activity. In finance, the blurring of territorial boundaries has been spurred by the deregulatory

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actions of national governments and by the development of multinational corporations, which tend to diversify their operations on a worldwide scale (Helleiner, 1994; Kapstein, 1994). Moreover, information technology has transformed the finance sector such that currencies, stocks, and shares can be traded electronically and instantaneously around the globe. Global market integration has been accompanied by the efforts of national governments to harmonize the regulatory framework of financial business. Rules providing for the safety and soundness of financial transactions are increasingly formulated in supranational or even global arenas by nation-states in bi- and multi-lateral negotiations. Although the European Union's (EU's) Single Market Program is the most prominent example of the growth of supranational efforts in market integration, international regimes (Krasner, 1983) such as the Basle Committee in banking (see Kapstein, 1994) or the International Organization of Securities Commissions (IOSCO) (see Coleman & Underhill, 1995) in securities, play crucial roles in harmonizing regulatory frameworks on the global level.

Even if one is not willing to postulate the "end of geography" (O'Brien, 1992) in financial business, the increasing integration of financial markets nevertheless implies changing opportunities and constraints faced by domestic financial firms and governments: For global players among banks the choice of geographic location is greatly widened. Even those financial actors that do not compete directly in international markets are under pressure to support the restructuring of their domestic market according to international price and product standards. Nation-states have found that their rule-making authority, historically grounded in the clear demarcation of territorial borders, is increasingly undermined. Their capacities for decision making are restricted by the pressures that international competition imposes on their territory and by the requirements that consensus in international platforms of decision making might place on them.

As incentives for domestic actors change through internationalization, we expect to observe changes in the domestic relations of power within national systems of financial governance. By financial governance we refer to the set of institutions (whether public or private), and the relationships among them, that regulate and supervise financial activities. In both the United States and in Germany, authority for financial regulation is partly divided, partly shared between the federal level and the states—we call this regulatory federalism. Within the financial governance system of the United States, regulatory federalism has historically been quite strong in the banking industry due to the functional and geographic fragmentation of regulatory responsibilities (but much less so in the securities industry). In Germany, it is more the securities rather than the banking industry that has been characterized by a strong

regulatory federalism. In both countries, regulatory federalism has been part of a broader financial federalism, that is, not only did regulation embody a federal dimension but so too did the very structure of the market and the behavior of market actors.

In the United States, the dual banking system divided banking markets largely along state, or even substate, lines. Although there have long been money-center banks operating on a national and international level, the vast majority of American banks operated in rather small (geographic) markets. In Germany, securities trading has been divided among eight stock exchanges (most of which focus on regionally traded shares) operating under the auspices of their respective state governments. In Germany, similar to the United States, a very large proportion of banks are small and operate in local markets but collectively account for a large share of all bank business in the country. These economic and political facets of financial federalism are interdependent: A stable division of regulatory power between different levels of the state was grounded in the fact that financial market actors roughly corresponded in their business activities to the same territorial demarcation. Financial federalism therefore implies that geography matters; the demarcation of different territorial spheres of political and market activities was the precondition for stability in each country's system of financial governance. But against the background of recent and ongoing changes in international financial markets, this precondition no longer seems given.

The theoretical focus of this article is twofold: First, we are assessing within the "second image reversed" tradition (Gourevitch, 1978; Katzenstein, 1978; Milner & Keohane, 1996) how financial internationalization has affected the policy preferences of private and public actors and, in turn, produced changes in the relations of authority among different levels of the state. Similar to Milner and Keohane (1996) and Frieden and Rogowski (1996), we assume that domestic actors' policy preferences are derived largely from the market incentives they face.¹ Our findings indicate that in both countries, the preferences of major actors have shifted in favor of policies that bring each country's market structures and regulation closer to emergent international standards, or what we call hegemonic models. As a result of these preference (and market) changes, we argue that the systems of financial federalism in both the United States and Germany have been undergoing a process of centralization. This means that federal authorities, mostly in coalition with globally oriented financial interests, are gaining power relative to the states and

1. Although we acknowledge that preferences are not always or strictly determined by economic position, we believe that for the cases we examine market incentives provide an adequate explanation.

locally oriented financial firms. For example, in Germany, it was a powerful coalition of large universal banks and the federal government that created a new body for securities regulation on the federal level, whereas in the United States, the federal banking regulatory agencies became the driving forces of the process of deregulatory competition with the states.

By highlighting the causal mechanisms behind these processes of institutional change, we take issue with the widely debated question of whether the sources of change are either mostly externally (“outside-in”) or mostly internally generated (“inside-out”) (Gourevitch, 1996; Sobel, 1994). Our findings suggest that this dichotomy is often of little use in comparative theorizing. The German case shows the importance of the increasing embeddedness of the German financial marketplace in the international political economy: Due to international market pressures and its involvement in international arenas of interstate collaboration, the federal government aggressively pursued regulatory change and gained power vis-à-vis the state governments. In the United States, however, institutional and regulatory change has been driven by a much more complex mixture of domestic and international forces. We argue that in neither case can domestic or international factors alone adequately explain the respective outcome. In both the German and American cases, domestic and international factors mattered, even as the relative importance of these two sets of factors clearly varied substantially between the two cases.

Given that institutions mediate between market-driven preferences and actual policy outcomes, we expect that internationalization affects policies and institutions differently from country to country (for similar views, see Garrett & Lange, 1996; Levy, 1997; Zysman, 1994). From this position, we take up, second, the evermore popular convergence question, that is, to what extent is there convergence across national systems of financial governance? In what way do political institutions block and refract the effects of internationalization (see Berger & Dore, 1996; Crouch & Streeck, 1997; Goldthorpe, 1984; Kitschelt, Lange, Marks, & Stephens, 1999)?

We argue first that those states that wish to be more or less fully integrated into the international financial system and remain competitive are increasingly required to meet certain minimum requirements on national systems of financial governance. These requirements are not fixed but evolve as international markets develop. Some of them are established by the common expectations of dominant market actors, for example, international institutional investors’ demand for market transparency; some of them are established through international agreements among state authorities. In this sense, there is convergence toward hegemonic models in market structure and regulation in banking and securities, and the mechanisms of convergence are therefore

both market (price) signals and authoritative decisions of state actors. In securities markets, the U.S. model of regulation is essentially the emerging internationally hegemonic model (compare Coleman, 1996; Lütz, 1998; Moran, 1991). This model emphasizes low restrictions on product and market innovation but high investor or consumer protection under strict state oversight (as opposed to frequently opaque self-regulation found elsewhere). In banking markets, the universal banking model, of which Germany is a prime example (on this model, see Deeg, 1999), is hegemonic. In this model, financial institutions face few restrictions on their activity; thus, singular and large financial conglomerates tend to take a strong position in all financial markets, including banking, securities, and insurance.

In both Germany and the United States, meeting the minimum requirements of each hegemonic model led to the centralization of regulatory authority. At the same time, however, convergence toward centralization (including harmonized regulation) and a stronger federal role is being filtered by the distinctive institutional framework each of the two political systems provide. Thus, despite obvious convergence toward hegemonic models in financial market structures and regulation, there is considerable scope for significant differences to remain across nations. We therefore provide in this article much-needed empirical evidence that supports a middle-ground position in the debate between those who argue in favor of convergence (Andrews, 1994; Goodman & Pauly, 1993; Milner & Keohane, 1996) and those more apt to reject it (Garrett, 1995; Pérez, 1998; S. K. Vogel, 1996).

The second section describes the models of financial federalism as they governed the United States and Germany up to the 1970s. The third section highlights the most distinctive global market changes and their implications for the power relationships within domestic systems of financial federalism. Afterward, the process of centralization in each federalist system is described and linked with the changing preferences and strategies of domestic actors. Finally, transformation processes in both countries are compared and differences in convergence analyzed.

THE OLD MODEL OF FINANCIAL FEDERALISM IN THE UNITED STATES AND GERMANY—FEDERALIZED CARTELS

It is often argued that the German financial system in general exhibits a federalist character. The three dominant banking groups—private commercial banks, public savings banks, and private cooperative banks—have either legally or functionally interdependent operating units in local, regional,

national, and international markets. The stock exchange system is regionally bounded as well. Although the Frankfurt exchange covers about 75% of market turnover, there are seven additional regional exchanges that mostly specialize in trading regional shares. However, the notion of financial federalism has to be differentiated if we consider the structure and mode of regulation in the German financial sector. In the subsector of banking, for example, authority for the supervision of market actors is located on the federal level in an autonomous federal agency (Bundesaufsichtsamt für das Kreditwesen [BAKred]), subject to general oversight by the Federal Ministry of Finance. The BAKred shares regulatory duties with the German Bundesbank (central bank) and the peak associations of the three banking groups. The German state governments (Länder) have no direct mandate in banking regulation except in the savings banks sector, partly owned by communal and state governments, where the states exercise supervision additional to that of the BAKred. In general, the regulatory structure in banking may be qualified as relatively centralized and, because policies are coordinated mostly between federal state bodies and peak associations, a corporatist type of sharing regulatory powers between public and private actors prevails (also see Coleman, 1996, pp. 129-133). Rather, it is more the German securities and stock exchange sector where a culture and practice of federalism has shaped the structure and mode of market regulation.

German stock exchanges first developed on the regional level and served as general meeting places for merchants to exchange goods, information, and later also equities. Organized markets were mostly implemented by local chambers of commerce and enjoyed the status of public law bodies. Internally, the exchanges were governed by a number of self-regulating committees that dealt, for example, with admission to security listings, with fees for equity trading, or with disciplinary procedures when exchange rules were breached. It was mostly the producers of financial services, that is, issuers of equities, stockbrokers, and in particular, the large universal banks that held the majority of seats in these self-governing committees; individual investors had no voice in them.

The severe economic crisis of 1873, followed by the stock market crash of 1891, spawned a debate over whether to tighten the mode of sectoral regulation in securities trading by including the state in the oversight structure. Turf battles over the distribution of regulatory authority ensued between the federal (but Prussian-dominated) government of the newly founded German nation-state and the majority of the states. The latter turned out as the winners of this conflict—the Länder were asked to appoint state commissioners to oversee the implementation of federal and state law. However, the states restricted themselves to a form of legal supervision over their respective

exchanges and, by granting licenses for self-regulation to private actors, basically practiced a politics of nonintervention. This policy was continued after World War II, when eight regional stock exchanges were reestablished and the Stock Exchange Legislation became part of Article 74 of the German Basic Law. The state governments were granted codecision rights over stock exchange matters, which allowed them to bargain in the Federal Council (Bundesrat) over the approval of new legislation. Responsibility for coordinating the policy objectives of these many Länder bodies was given over to a permanent committee (Arbeitskreis für Börsen- und Wertpapierfragen) where ministers and government officials of the state finance or economics ministries were represented. In cases that touched the federal authority in stock exchange legislation, representatives of the Federal Ministry of Finance and of the Central Bank joined the committee.

The German model of financial federalism therefore very much resembled regional cartels between states and stock market actors, with both groups joined together by their common interest in defending their sphere of influence against intervention by the federal state. For market actors, the model of sectoral self-regulation was a very comfortable one because it involved low regulatory costs. In effect, the community of producers of financial services themselves decided on the costs they were willing to assume for the sake of transparency and openness of their market transactions. Because it was primarily large German universal banks that were engaged in issuing and trading shares, it was their solvability, guaranteed by adequate capital reserves under the oversight of the banking regulatory agencies, that provided for losses through systemic crises in securities markets. Conversely, insider trading was not criminalized, neither were disclosure rules allowing transparency over the issuance, registration, and trading of securities established. Investors had no choice other than to trust in the functioning of self-regulation.

The German states, similarly, had no reason to intervene into stock exchange matters as long as the sector was not shaken by crises or by external threats. Moreover, Länder and market actors built strong coalitions, particularly against efforts to penetrate the model of regional self-regulation through such measures as the incorporation of regulatory matters into federal law or the establishment of a federal supervisory agency. Both federal government and Länder agreed on a state of friendly coexistence, which was only occasionally turned into a form of cooperative federalism (i.e., sharing responsibility).

Similar to the German type of financial federalism, the U.S. model of banking regulation rested on a consensus among the federal and state governments not to intervene into the regulatory jurisdictions of each other. In contrast to Germany, however, self-regulation did not play a significant role in

the U.S. banking model, where statutory authority for regulation rested in both state and federal laws. Under the dual banking system, banks chartered under state laws are primarily regulated by state authorities; national banks (and bank holding companies) chartered under federal law are primarily regulated by federal authorities. Under this system, the federal government and each state had its own more-or-less separate sphere of influence. Regulatory competition among states and between the federal and state governments was therefore mostly latent.² Consensus among the federal and state governments and stability in regulatory federalism also were based on limiting competition between banks of different kinds. Most current federal and state regulation was developed in the wake of the 1930s banking crisis and was strongly guided by the overarching goals of systemic stability and depositor protection (deconcentration of bank sector assets also was seen as part of this). Fragmentation in markets and regulation were accepted as trade-offs for safety and stability. Competition was limited primarily through market entry barriers (including geographic expansion restrictions), price controls, and financial product restrictions (including market segmentation). In other words, markets were segmented along geographic and functional lines. Price competition was limited primarily by interest rate regulation. Receiving a bank charter required demonstration of prospective safety and soundness and the need for another bank. This enabled federal regulators such as the Office of the Comptroller of Currency (OCC) for national banks, and state regulators for state banks, to prevent new entrants in markets deemed sufficiently well served. Indeed, regulators were generally slow to grant new charters (White, 1994, p. 23). More important for entry restrictions, however, were limits on interstate banking, interstate branch banking, and intrastate branching. These restrictions were governed by state laws (a right reserved for states in the federal 1927 McFadden Act).³

Most important, however, were functional market barriers through which regulators intended to guarantee the safety and soundness in the financial system. The well-known Glass-Steagall Act of 1933 placed significant limits on permitted commercial banking activities and, most notably, enforced a strict separation of commercial and investment banking activities. In general, then,

2. This assertion is qualified by the fact that all state banks have a companion regulator at the federal level (either the Federal Reserve or Federal Deposit Insurance Corporation [FDIC]) that allows for some federal intervention at the state level. Moreover, despite widespread consensus on the sanctity of the dual banking system, there was some competition among regulators to encourage banks to charter under their auspices. We are indebted to William Coleman for this point.

3. In the early 1970s, most states restricted intrastate branching and virtually all states banned or severely restricted interstate banking and interstate branch banking (White, 1994, p. 23).

three basic kinds of banking institutions existed and could not enter the market segments of the others: investment banks and brokerage firms conducted securities-related activities, commercial banks conducted commercial and consumer banking, and thrifts provided residential mortgages and conducted limited commercial and consumer banking. These banking institutions also were largely prohibited from engaging in insurance activities.

Tight restrictions on competition in the United States obviously reduced the need for prudential bank regulation because restrained competition was deemed to reduce the likelihood of insolvency. Regulations on asset allocation, capital adequacy (solvency), and reserve deposits (liquidity) were not as formal or systemized as German prudential banking regulation. Although capital adequacy regulation was important for all bank regulators in the United States, no fixed, harmonized standards for measuring capital adequacy existed. Different regulatory authorities followed ad hoc rules and their best judgment in assessing bank solvency. Although this allowed for the special circumstances of individual banks to be considered by bank examiners, it also led to inequitable treatment across banks.

Thus during the post-Depression period a cartel-like regime with state and federal regulatory agencies acting as the enforcers was maintained: higher profits, stability in prices and bankruptcies, barriers to entry, and growth in inefficient operating expenses characterized the financial industry. (Hammond & Knott, 1988, p. 15)

There was no nationwide branch banking system in the German sense, that is, no single banks operating comprehensive branch networks throughout the nation. Rather, the U.S. banking system was comprised essentially of thousands of highly regulated local bank oligopolies—a stable market and political arrangement.

INTERNATIONALIZATION OF FINANCIAL MARKETS AND THEIR IMPLICATIONS FOR DOMESTIC ACTORS

Within the last two decades, financial markets have experienced a period of fundamental transformation characterized by two broad developments: first, distributional shifts between different types of banking activities, and second, changes in the regulatory framework of financial business. Probably the most important distributional shift is that banks, as the classical financial intermediaries, are increasingly bypassed by borrowers who prefer to

transform their liabilities into tradable securities because this is generally a much cheaper way of raising capital than relying on bank credits. The internationalization of financial markets significantly boosted this trend toward securitization by providing large borrowers with greater opportunities for bypassing domestic banks and creating more competition among domestic and foreign financial firms. It is obvious that these structural changes put immense pressure on commercial banks in particular because they are increasingly bypassed by large customers and are left with smaller firms that are often less creditworthy and less profitable. With declining loan business, the only strategy of survival for commercial banks is expansion into new and more profitable lines of business such as investment banking. Those commercial banks that already act as universal banks will further broaden their activities; banks hindered by legal restrictions from expanding their lines of business will lobby for the dismantling of market barriers. Both strategies will result in further desegmentation of financial business and lead to the development of a new hegemonic model of universal banking with a stronger emphasis on investment banking activities than ever before.

Changes in the regulation of financial activities accompany these structural shifts in financial business. In systems where universal banking is the dominant model of financial business, such as Germany, financial regulators put emphasis on the solvability of producers of financial services. Because these banks are engaged in a wide range of activities, not only including deposit taking and lending but also issuing, trading, and underwriting securities and insurance, bank failures could more easily provoke chain reactions and severe repercussions for the whole economy. Universal banks are therefore held to strict liquidity and solvency regulations—most important, adequate capital reserves—to protect their customers against financial losses and to limit systemic risk.

In contrast, regulation in financial systems with a traditionally greater emphasis on securities markets financing, such as the United States, encompasses stricter requirements on information disclosure to ensure adequate transparency of market transactions. In such systems, the pure type of investment banking business is more short-term oriented because these firms are typically engaged in rapid asset turnover. This is why solvability requirements are not as restrictive as in the classical type of universal banking system. Because relationships between intermediaries and customers are more arms-length than in the classical type of banking, regulators focus more directly on minimizing risks to individual investors, or consumers, than on rules providing for the soundness of financial producers. Transparency over market conditions mostly favors the investor, who is thereby able to choose among the most attractive financial intermediaries.

Each of our two countries partially fitted and partially mismatched the new institutional requirements of international competition, that is, the combination of universal banking with well-developed and transparent securities markets. The U.S. financial system traditionally relied on the size and strength of the domestic securities market. In the subsector of securities markets and investment banking, the United States in fact represents the globally hegemonic regulatory model, with a strong focus on investor protection enforced by a very powerful independent regulatory agency, the Securities and Exchange Commission (SEC). The subsector of commercial banking, however, was comparatively underdeveloped in universal banking terms: Commercial banks were legally restricted in the lines of business they could engage in, and the risk of banking failures was prevented more by the restriction of competition than by elaborate prudential regulation.

Conversely, the German model traditionally relied on universal banks as financiers of German industry (Shonfield, 1965). Systemic risk was minimized through elaborate prudential regulation that was overseen by a federal supervisory agency and the Bundesbank. In Germany, it was the stock exchange sector that did not meet the requirements of the new hegemonic financial model: Securities markets were underdeveloped, as was the system of sectoral regulation. Regional self-regulation governed trading activities and producers defined the degree of market transparency, whereas investors were excluded from the self-regulatory system. Therefore, both countries had to solve different problems of institutional adjustment to meet the minimum requirements of global markets: Whereas the United States faced immense pressures from commercial banks to lower the existing barriers to universal banking, German banks pushed for modernization of domestic securities markets. Consequently, in both countries, we see movement to a mixture of producer- and consumer-oriented types of financial regulation.

IMPERATIVES TO RESTRUCTURE THE GERMAN SYSTEM⁴

At the end of the 1980s, German banks and the federal government faced strong pressures to reorganize the sectoral governance structure of the financial system. First, large German firms were borrowing less and less from domestic banks and were increasingly borrowing directly from capital markets, especially foreign. These firms also were increasingly passing over domestic banks in favor of foreign investment banks (Deeg, 1999). Second, German large universal banks, for all their size and prowess at home, needed to catch up in international competition and especially to launch an offensive

4. This section draws heavily on Lütz (1998; see also Deeg, 1999).

in international investment banking. Hence, at the international level, major German banks began acquiring or establishing investment banking houses in London and New York. At the domestic level, the banks engaged in the reorganization of their home securities market to overcome its comparative underdevelopment. Because domestic demand for securities was relatively weak, German banks attempted to attract foreign investors to their domestic stock market to catch up with other leading financial centers.

But international investors were now able to choose their trading places on a global level. Moreover, they did not even need to choose the German marketplace to invest in German securities—in 1990, the trading of the most liquid German shares at the London Stock Exchange represented about 13% of their turnover on the domestic market. Financial futures exchanges in London and Paris offered Deutsche mark (DM) contracts and DM securities markets grew outside of the country, with the center of the Euro-DM market being in London, followed by Luxembourg and Paris.

There were several reasons for this lack of foreign investor interest in the German market: First, the costs of stock market transactions (i.e., brokers' commissions, costs for clearing and settling deals) were relatively high, whereas product innovations offering risk-management opportunities were lacking. Second, and more important in its structural implications for the German system of sectoral governance, the German model of self-regulation in securities markets was not trusted by outsiders. Given the opaqueness of the self-regulated system, investors argued, one could trust neither the soundness of price setting nor the willingness of monitors to sanction market malpractices. In addition, German banks were blocked by foreign regulatory bodies when they tried to distribute their product innovations abroad. For example, member firms of the German Options- and Futures Exchange (Deutsche Terminbörse [DTB]) were eager to sell their latest financial innovations (DAX-options) to U.S.-based financial firms and money managers. The U.S. SEC, however, prohibited trading of these products in the United States by arguing that they came from a market that operated under lower regulatory standards than the United States. Because the SEC sees protection of domestic investors as its primary mission, it has repeatedly pushed foreign market actors to guarantee U.S. investors the same level of protection they enjoy at home (compare Moran, 1991).

Although German banks still maintained that their model of self-regulation worked, they nonetheless realized that it had become a major liability in the global competition for investors. To participate in the global market, it became clearly necessary to prove one's fairness and honesty as a financial firm by operating in a tightly regulated market under close state supervision.

Political actors, particularly the Federal Ministry of Finance, faced their own competitive and collaborative pressures to reorganize the domestic securities industry. First, the ministry was eager to modernize the German financial marketplace in order to compete head-to-head with London and Paris in the emerging single European equity market (see Story, 1997, p. 261). An effective system of market oversight, protecting against insider trading and providing for equal treatment of shareholders, was considered essential to boosting domestic competitiveness in these matters. When Finance Minister Waigel announced his strategy to push the "Finanzplatz Deutschland [finance center Germany]" in 1992, the establishment of a centralized supervisory body for the German capital market was a crucial part of it.

Second, collaborative pressures to engage in the growing interstate coordination on issues of financial regulation had emerged on the international and on the European level. International collaboration has been driven mostly by states' interests in preventing the cross-border spread of market risks or of financial institution failures. Cooperation entails negotiations over the harmonization of supervisory standards and cross-border contacts between domestic regulatory bodies aimed at monitoring and enforcing rules. Interstate cooperation is practiced on the bilateral and on the multilateral level. Bilateral Memoranda of Understanding (MOUs) between domestic regulatory agencies were until the early 1990s the predominant form of regulatory coordination in the securities sector (see Baumgardner, 1990; Bernhard & Blumrosen, 1993). MOUs tend to be highly technical and fix the rights and duties involved in the exchange of information between different regulatory bodies. They also provide for mutual assistance in the investigation of securities law violations. Further international regulatory coordination takes place in the IOSCO, an international regime of national regulatory bodies. During the 1980s, IOSCO was transformed into a global platform for coordinating and harmonizing regulatory standards (Coleman & Underhill, 1995; Porter, 1993).

Most important for Germany, multilateral coordination on matters of securities regulation has been promoted within the EU. The EU's Single Market Program of 1985 intended to push the interstate collaboration in these matters. Some of the most important EU initiatives are the directives on Insider-Trading ("Coordinating Regulations," 1989) and on Investment Services ("Directive," 1993), which are aimed at generating a network of collaboration among the regulatory bodies of member states. Both directives link the creation of a Single European Market for securities with the principle of home country control (see also Kapstein, 1994). That is, they require member states to specify a supervisory body for the securities sector that can cooperate closely with its foreign counterparts. Since the mid-1990s, multilateral

cooperation in matters of securities regulation has intensified further on the European level. For example, in December 1997, the Forum of European Securities Commissions (FESCO) was founded by 17 national securities regulators to reinforce the harmonization of investor protection rules and to exchange information in cases of cross-border fraud. The founding of FESCO clearly indicates growing European intergovernmentalism in securities matters. However, a supranational financial oversight body is not yet in sight because domestic regulators are still defending their national turf.

Against this background of an evolving global network of interstate collaboration, the German Federal Ministry of Finance felt that Germany was losing influence over the evolving terms of international competition and was therefore falling behind its competitors. For example, Germany was excluded from the circle of bilateral exchanges because it had no legal procedure for cross-border investigations in cases of insider dealing. Moreover, on the EU level, Germany was unable to meet the requirements for collaboration among domestic regulatory bodies of member states. Similar collaboration failures happened in IOSCO, where mostly public regulatory bodies are allowed to participate in the core decision-making processes. Because Germany had no single public regulatory body for securities markets, it was excluded from these decision-making procedures. Thus, for political reasons, which were closely linked with the changing market environment, the federal government decided it must acquire greater regulatory control over its domestic securities sector.

IMPERATIVES TO RESTRUCTURE THE U.S. SYSTEM

For U.S. commercial banks, their drive to restructure and deregulate the domestic banking sector began primarily out of domestic developments. In the 1970s, the more-or-less stable equilibrium in the U.S. system of financial federalism began to break down. Once this old equilibrium was disturbed, a deregulatory dynamic—not controlled by any particular actor or coalition—was unleashed as increased competition among financial firms added more pressure for more deregulation in order to level the playing field across different kinds of financial firms or simply to gain access to new market segments. The fragmented nature of the U.S. regulatory system, as well as the involvement of the courts, contributed to this dynamic: As one financial firm or set of firms gained a regulatory/market advantage, others would seek a compensatory regulatory change from a different regulator or the courts. In this sense, competition among regulators promoted further deregulation as well (also see Cerny, 1994). The deregulatory process in the United States also was driven by the need to respond to some unintended consequences of

earlier deregulatory reforms. The savings and loan (S&L) crisis of the late 1980s, for example, poured cold water on the efforts to repeal Glass-Steagall but boosted the trend toward interstate banking because federal agencies cleaning up the mess readily sold failed thrifts to out-of-state banks. Although these domestic factors can explain a great deal of the regulatory reform in the United States over the past 20 years, they alone are insufficient in our view. First, it is frequently difficult, if not impossible, to separate certain domestic from international pressures for change. For example, the securitization trend in the United States is driven by both domestic and foreign market actors (compare Reinicke, 1995, pp. 40-52). Second, since the mid-1980s, concerns for the international competitiveness of U.S. financial firms have been at the center of the domestic policy debates, especially regarding the repeal of Glass-Steagall. Large U.S. banks, the Federal Reserve, and the Treasury have all consistently argued for repeal by invoking the international competitiveness issue. This was not simply rhetoric because the growth in competitive pressures from foreign markets and financial institutions is quite real.

Since the early 1970s, commercial banks have faced growing competition from other financial institutions not constrained by the same price and regulatory controls. Because the Federal Reserve kept deposit interest rates low in the late 1960s and early 1970s, even as interest rates in the financial system were rising, savers increasingly looked for more attractive investment opportunities and began to find them outside of U.S. commercial banks, for example, in money market mutual funds offered by securities houses. Some banks, especially S&Ls, sought to have price controls extended to these new financial competitors and products, especially to money market funds, which had become a serious threat to banks. But these efforts were politically untenable: Many savers had come to favor money market funds and restrictions on them would prove politically unpopular. The new financial competitors to banks, notably securities houses, also used their political clout to resist price regulation. Finally, the political climate during the Carter administration was pro-deregulation. Unable to have price regulation extended to these new competitors and faced with growing disintermediation, banks pursued the only alternative—to throw off price and product controls so that they could compete on an equal footing (Hammond & Knott, 1988, pp. 15-19). Thus began a series—both successful and unsuccessful—of deregulatory efforts in financial services, including numerous unsuccessful attempts to repeal Glass-Steagall.

Beginning in the mid-1980s, the growing internationalization of banking markets began to affect the terms of the domestic regulatory debate in the United States (see Reinicke, 1995). Specifically, the international

competitiveness of the U.S. banking system came to be seen as seriously threatened (notably by Japanese banks). Foreign bank share was rising sharply in the United States through expansion and acquisition of U.S. banks. Foreign bank share of U.S. banking assets, for example, rose from 5% in 1978 to 13.5% in 1992 (White, 1994, pp. 23-24). The long preeminent position of U.S. banks in international banking was eroding.

Moreover, further competitive pressures were arising from foreign political actors. For much of the postwar period, large U.S. commercial banks had generally been permitted (by U.S. regulators) to act as universal banks abroad to circumvent domestic barriers to broader financial activities (and remain competitive abroad). Large U.S. banks were among the most active in utilizing Euromarkets since the late 1960s to develop new markets and circumvent restrictive domestic regulations (Kapstein, 1994; Moran, 1991). The efforts of the EU to integrate its financial market in the 1980s, however, threatened to abolish this exit option. The EU, backing its own banks, specifically threatened to adopt a policy of reciprocity, which would have meant that U.S. banks would only be permitted to do in Europe what European banks could do in the United States. Thus, if European banks could not act as universal banks in the United States, then neither would U.S. banks be able to compete as universal banks in Europe—a market largely dominated by universal banks. Because most U.S. banks in Europe operated in investment banking, this would have meant a severe constriction on their foreign activities.

Thus, in the mid-1980s, not only domestic banks but also federal regulators were confronted with a menacingly weak and increasingly uncompetitive banking system. Moreover, the growing internationalization of the domestic market, and the fact that more and more banking business was being conducted by foreign banks whose U.S. operations were but one part of their global business, made regulators' objective of guaranteeing the safety and stability of the banking system an increasingly difficult challenge. The fear of further competitive losses of the national banking system vis-à-vis foreign counterparts and other financial intermediaries and the dangers evolving for individual bank and systemic stability drove federal authorities to strengthen their efforts in sectoral restructuring.

THE NEW MODELS IN THE UNITED STATES AND IN GERMANY—TOWARD FURTHER CENTRALIZATION OF THE FEDERALIST SYSTEM

In both countries, financial companies and government authorities faced pressures to adapt the domestic institutional and regulatory framework of

financial business to the changing environment. However, the two countries had to solve quite different tasks of restructuring: U.S. actors predominantly engaged in lowering the legal barriers to universal bank business and nationwide banking (deregulation), whereas German actors raised the standard of investor protection in the securities sector (reregulation). But both countries took the same direction of institutional change toward a stronger role for the federal level within their domestic framework of financial federalism. A key reason for this institutional shift was that in both countries, although to a different extent, alliances of globally oriented market and political actors gained power vis-à-vis regionally bounded ones. Hence, the formerly stable model of power sharing in each federalist system eroded.

THE NEW GERMAN MODEL

As has been shown already, in Germany it was the large universal banks together with the Federal Ministry of Finance—the coalition of global players—that placed the need to meet international standards of regulation in the center of the domestic policy debate.⁵ Although the decision to tighten the system of investor protection and to establish a government regulatory body for market supervision was forced by the need to implement the EU's Insider-Trading and Investment Services Directives into German law, the manner in which it was to be implemented was not pre-given and involved considerable political maneuvering. The coalition of global players strongly preferred a federal (centrist) solution to the oversight problem, modeled on the U.S. SEC. A new, federal agency under the jurisdiction of the Federal Ministry of Finance was to be established, charged with the supervision of insider trading and tasks associated with international representation. It is important to note that this coalition was joined by the state government of Hessen (in which Frankfurt is located), which from the beginning of the discussion about restructuring the German financial marketplace had promoted the position of the Frankfurt-centered universal banks. Moreover, Hessen even acted as the “first mover” in questions of reregulation by strengthening its own state oversight system over the Frankfurt Exchange. The state commissioner of Hessen got further authority to actively supervise the exchange (instead of just pure legal oversight) and hired further employees for supervisory tasks. The costs for these widened regulatory duties were carried by the Exchange of Frankfurt.

Hessen's actions were important because they put additional pressure for a centralized reform solution not only on the Federal Ministry but also on the

5. This section draws heavily on Lütz (1998).

other German states. Although the other states realized that Hessen had broken ranks with them, most opted not to follow Hessen's move and thereby maintain some sort of competitive parity between their own exchanges and Frankfurt. Because the seven other exchanges were of considerably smaller size, the much greater costs of active state supervision seemed unbearable to these states. They therefore made a counterproposal to create a common supervisory body—jointly run by the states—instead of widening their own individual oversight tasks. Not surprisingly, this proposal met resistance from the global, centrist coalition, which feared that an agency carried by a “conglomeration of German states” would lack clear international visibility and would not meet the requirements for international collaboration. However, a compromise was needed because the states could use their codecision rights in the upper federal chamber (Bundesrat) to veto pending federal legislation to create a federal supervisory body.

Turf battles raged for about 1 year before the globally oriented coalition emerged as the winner. A new regulatory model was decided in 1993, the crux of which was a supervisory agency for securities trading (Bundesaufsichtsamt für den Wertpapierhandel) under the jurisdiction of the Federal Ministry of Finance. Its tasks involve the surveillance of large share transactions and rules of conduct in securities trading. Moreover, the agency enforces a strict regime controlling insider trading and, in particular, represents Germany in international circles of securities regulation. Although the German states did not achieve their original objective, their formal rights to supervise their respective securities exchanges were expanded, especially to oversee market transactions and conduct their own investigations of misdoings. A new Securities Council (Wertpapierrat) was founded to enable the states to provide input (but not decision-making rights) into federal securities regulation. The stock exchanges themselves lost power because formerly self-regulated matters became the subject of federal supervision or were now regulated in public law. The exchanges were required to set up new bodies for supervising stock exchange trading (Handelsüberwachungsstellen), whose tasks are to collect data electronically on market transactions and to collaborate closely with the federal agency. In general, a complex regulatory structure with partly overlapping responsibilities of the states and the new federal regulator has evolved that reflects the kind of “interlocking politics” characteristic of the German model of federalism (Scharpf, Reissert, & Schnabel, 1976). Regulatory practice has shown that direct contacts between the federal level and the stock exchange level prevail, whereas, at least in some German states, regulatory supervision is more of symbolic character. This is not surprising because most German states are suffering from severe budget restraints and they cannot take their regulatory duties too seriously.

In the late 1990s, pressure toward further concentration of stock exchange trading and centralization of regulatory oversight on the domestic level has increased. The integration of capital markets imposed by the European Monetary Union (EMU) is expected to lower profit margins in securities trading because institutional investors will more easily switch their business to the most liquid markets with broad product diversity and low trading costs. In the long run, these cost pressures will leave no place for the 32 stock exchanges and 23 futures and options exchanges currently operating in Europe. It is for this reason that the Frankfurt coalition of large universal banks and the state of Hesse developed a plan to replace at least 6 of the 8 German exchanges with an electronic trading network by 2000. This strategy should further enable Frankfurt to gain market share on the European level by linking its electronic trading platforms with other exchanges. Toward this end, in 1998 the Frankfurt exchange announced a strategic alliance with its former rival—the London Stock Exchange; 1 year later, both exchanges opened up their bilateral talks to 6 other exchanges (Amsterdam, Brussels, Madrid, Milan, Paris, and Zurich). If successful, this alliance will create a pan-European electronic exchange that integrates trading in some 300 of the most liquid European blue chips (Luce, 1999).

If Frankfurt's strategic concept becomes reality, there will no longer be even the slightest reason for upholding the already weakened federalist structure of regulation. Indeed, the Federal Ministry of Finance already announced that the Fourth Financial Market Promotion Law (scheduled for passage in 2000) will further centralize supervision of German capital markets in the federal securities supervisory agency. Given that the German states could again make use of their codecision rights in the upper federal chamber (Bundesrat) to veto this legislation, turf battles are likely to postpone the final decision about the future model of capital market oversight. Nevertheless, it is quite apparent that the former equilibrium of power in the German system of regulatory federalism has been shifted in favor of those actors most pressured by the international political economy.

THE EMERGING U.S. MODEL

In the United States, it has been a looser and shifting coalition of political and market actors that has driven the process of lowering geographical and functional market barriers, that is, promoting universalization in banking. Up to the 1980s, deregulation of the banking industry was driven largely by the states, whose former state of friendly coexistence had been transformed into deregulatory competition. Beginning in the 1980s, it was federal regulators, especially the Federal Reserve and OCC, that took the position as the main

protagonists in the struggles over repealing the barriers between commercial and investment banking by unilaterally lowering market barriers.

Many early deregulatory measures focused on price competition and were completed by the beginning of the 1980s. They were largely born of domestic market and political competition and were especially motivated by the interests of large commercial banks in competing head-to-head with securities firms. One of the first key federal measures was the 1980 federal Depository Institutions Deregulation and Monetary Control Act (DIDMCA), which enacted a 6-year phase out of deposit rate ceilings (Regulation Q). In order not to be disadvantaged vis-à-vis commercial banks, thrifts (S&Ls) also sought and received authorization for new financial products and an expansion of their permissible activities in the act. Deregulation could not, and would not, stop here. Although banks could now compete with their nonbank competitors on price terms, banks were still far more limited in geographic and product scope and thus intensified their lobbying for relaxation of interstate banking barriers and repeal of the Glass-Steagall Act.

The move to interstate banking began with Maine's adoption of interstate banking legislation in 1975. Within a decade, virtually all states had passed some form of interstate banking legislation. Many states passed legislation in the hopes of attracting new investment capital. There also were leveraging effects at work because reciprocity clauses adopted by many states meant that if banks from one state wanted to expand into others, their own legislature had to pass reciprocating interstate banking legislation (see also Savage, 1993, pp. 1075-1077). Federal government actors also became enthusiastic about interstate banking because, in an increasingly deregulated market, continued limits on the ability of banks to diversify their risks by product and region now, ironically, raised instability in the financial system (*Federal Reserve Bulletin*, 1993; Hammond & Knott, 1988, p. 21). Thus, as the old equilibrium in financial federalism began eroding, a new regulatory logic—more akin to the German—was emerging. Accordingly, the policy preferences of regulators began to shift as well from pursuing stability in banking through restriction to stability through diversification and competition, combined with greater prudential regulation. Regulators also realized that banks and other financial firms were finding ways around stricter regulation (something the courts were facilitating). So to maintain their governing role in markets, they needed to change regulation in line with market developments.

The most dramatic move to nationwide banking, however, came in 1994 when Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act (Interstate Act). This act superseded the 1927 McFadden Act and the 1956 Douglas Amendment to the Bank Holding Company Act, which had given states the right to control interstate banking. "The new law

generally stands that approach on its head, giving the states certain limited decisions, while authorizing interstate branching and acquisitions as a matter of preeminent federal law" (Eager, 1995, p. 28). Thus, control over the process of deregulating interstate banking was finally wrested from the states by the federal government. Even before the Interstate Act, the previous decade had already seen some 80 interstate bank mergers involving large banks (more than \$1 billion in assets) (Rhoades, 1996, p. 9).⁶ Subsequent to the passage of the act there have been many more mergers, and concentration is expected to continue at a rapid pace (Rhoades, 1996, pp. 2-5). With the continuing consolidation of major regional commercial banks, the United States is witnessing the inception of its first true nationwide banks.

It is inevitable that the role of federal regulators will grow as a greater percentage of all banks (and bank assets) come under their authority as a result of concentration in the industry. Although state banks may also branch across state lines, they are at a comparative disadvantage because they will have to comply with all the bank regulations in each state in which they operate. In the case of national banks or bank holding companies, federal law preempts state laws; thus, federal regulators can apply more or less the same regulations to all branches of multistate national banks. States are therefore confronted with the threat that state banks will convert to a national bank charter to expand their business more easily (Eager, 1995).⁷ To mitigate such competitive disadvantages, states are under pressure to harmonize state regulations. But this raises serious questions about the future of the dual banking system in the United States. If state regulators do not coordinate and harmonize, they are likely to end up with fewer and smaller banks over which they exercise authority. If they harmonize, then they have lost considerable individual policy autonomy.

Perhaps most important among banking regulations, and most controversial, are those that enforced market segmentation in the financial system. Reform or repeal of the Glass-Steagall Act has been on the legislative agenda for two decades, but each major federal legislative reform initiative has failed for one reason or another. Nevertheless, the market segmentation prescribed by Glass-Steagall has steadily eroded throughout this period. The reason for this is that when federal legislators failed to act, federal regulatory agencies took the initiative and lowered market barriers in a piecemeal fashion.

6. Rhoades (1996) provides an extensive analysis of U.S. bank industry mergers between 1980 and 1994.

7. Just such a case arose in late 1996 when Keycorp—a Midwest-based bank holding company—announced it would take advantage of new federal interstate branching laws to merge its 12 separate state banks into one national bank operating branches in 14 states (Hansell, 1996).

In the early 1980s, the large commercial banks, after years of seeing their domestic market share in financial intermediation erode, launched an all-out initiative in Congress to get Glass-Steagall repealed (Reinicke, 1995). Although the Reagan administration was very sympathetic, the securities industry and smaller banks, together with local and state politicians, defended the status quo and held sway over the majority of congressional members and key committee leaders, especially in the House, where populist sentiment is strong. Despite repeated efforts over several years, this blocking coalition could not be overcome. Nonetheless, large banks found ways to circumvent Glass-Steagall by exploiting more permissive banking regulation in certain states (in effect pursuing regulatory arbitrage) or through court decisions that broadened their commercial banking activities.

The clamor for repeal of Glass-Steagall swelled in the mid-1980s when the crisis of the U.S. banking system was turned into a matter of vital national interest. Sharpened competition from foreign banks in the United States and threats from the EU to reduce opportunities for U.S. banks in Europe allowed the prorepeal coalition to recast the domestic policy debate from one about profits to one about national interest. Major foreign financial markets, notably London with its Big Bang in 1986, were reforming and becoming more competitive vis-à-vis New York. Universalization in banking was accelerating in many foreign countries, thereby altering the terms of competition between U.S. and foreign banks. All these changes greatly concerned the New York financial community and the Fed. Increasingly, Glass-Steagall appeared as a "Maginot Line" (Reinicke, 1995, pp. 94-96). By 1987, the prorepeal coalition had expanded and appeared to have gained the upper hand in Washington. Yet although federal regulators largely supported repeal, and resistance on the hill and even in the securities industry began to soften under the weight of competitiveness concerns, again no legislation made it through Congress. Legislative failure this time was due partly to continuing opposition from some key congressional committee leaders but also in good part to the S&L crisis of the late 1980s that placed members of Congress under heavy pressure from consumer groups opposed to further banking deregulation.

With Congress unable to act, federal regulators, with de facto support from the executive branch and even much of Congress, began allowing commercial banks to begin limited investment banking activities on a case-by-case basis. In 1987, a major breakthrough came when the Federal Reserve decided to allow bank holding companies to engage in investment banking activities—including underwriting corporate share issues—through separately capitalized subsidiaries. Underwriting revenues, however, could not exceed 10% of the total revenues. Despite this limitation, by the early 1990s,

banks had expanded into selling commercial paper, mutual funds, mortgage-backed securities, and discount brokerages.⁸ The prorepeal coalition now hoped that Congress would feel compelled to act in order to regain legislative control over the industry.

Indeed, by the late 1990s, nearly all of the financial services industry supported reform of Glass-Steagall. The securities and insurance industries, initially opponents of reform, had gradually switched their position as domestic and international market developments pushed them toward expanding beyond their own traditional lines of business to compete with emerging financial conglomerates. The prorepeal coalition continued to argue that repeal of Glass-Steagall would benefit domestic consumers and businesses and is vital to maintaining the international competitiveness of U.S. financial firms. The only remaining visible opponents were small banks and some consumer and small business groups. But despite this support among previously recalcitrant segments of the financial industry, Congress repeatedly failed to repeal Glass-Steagall. Although the structure of the U.S. legislative process enables an increasingly isolated but well-positioned and vocal minority to hinder legislation, more damaging to recent repeal efforts have been the remaining turf battles between the Federal Reserve and the Treasury. The Federal Reserve wants to see universal banking occur under a financial services holding company model that would give it greater regulatory authority. On the other side, the Treasury—backed by the White House—wants a simpler corporate banking model that would give the OCC greater regulatory role (Labaton, 1999).⁹

Repeated congressional failures spurred regulators to take matters into their own hands. In late 1996, the Federal Reserve raised the limit on bank affiliate underwriting revenues from 10% to 25% of total revenues. This gave banks enough room to move into investment banking in a big way and gave new impetus to the growing number of linkups between commercial banks and securities firms. Not to be left behind, in early 1997, the OCC began permitting some of its banks to diversify outside of commercial banking activities through bank subsidiaries (Hershey, 1996). Federal bank regulators also have begun permitting insurance companies and commercial banks to link up, as exemplified by the merger between Citicorp and the Travelers Insurance Group in 1998. Thus, whether Congress acts, the barriers between

8. By 1993, 17 states also permitted banks to engage in investment banking activities (*Federal Reserve Bulletin*, 1995, p. 350).

9. Another barrier to repeal has been the fight between many Republicans in Congress, who want to weaken the Community Reinvestment Act along with the repeal of Glass-Steagall, and the White House, which is seeking to preserve the Reinvestment Act as it stands.

investment and commercial banking will continue to come down—apparently at an ever-faster rate. Declining business in traditional commercial banking activities and growing competition—including from deep-pocketed foreign banks intent on becoming major universal banks in the U.S. market—are ineluctably driving the larger banks toward universalization (see also Blanden, 1996).

Tightly connected with deregulation in competition and universalization of banking business are changes in the mode of financial regulation that, in turn, add further competencies to the federal regulatory agencies. Regulators can no longer rely on market segmentation and restrained competition as sources of stability in financial markets. As in the German system, regulators must now focus more on prudential and capital adequacy regulations as the means to ensure individual bank and systemic stability (see also Litan & Rauch, 1998).

Faced with the declining equity position of the nation's banks in the early 1980s, the major federal regulatory agencies began discussing the formalization and standardization of capital adequacy standards. Banks, large and small, resisted these efforts but regulators received political reinforcement from Congress in the 1983 International Lending Act (ILA), which gave regulators statutory authority to set and enforce minimum capital adequacy standards. In 1985, the three main federal regulatory bodies adopted such standards and, in accordance with the ILA, pursued the adoption of international capital adequacy standards to prevent competitive disadvantages for U.S. banks (Reinicke, 1995, pp. 135-150).

INTERNATIONALIZATION AND THE DIFFERENT VULNERABILITIES OF FINANCIAL FEDERALISM

In general, our study reveals that internationalization processes are not simply about the growth of cross-border transactions because these processes frequently entail the relocation of public governance functions inside nation-states—through legislative acts, executive orders, court rulings, and also private corporate decisions. Both the German type of cooperative federalism and the U.S. model of competitive federalism proved to be vulnerable to the pressures that internationalization in financial markets imposed on them. In both systems of financial federalism, power shifted toward those actors that, for different reasons, are most sensitive to the global economy and away from more regionally bounded interests.

On the market side, it was those banks, eager to expand functionally and geographically their business lines to meet international standards of

competition, that actively engaged in sectoral restructuring and disrupted the historic equilibrium in each country's financial federalism. In the United States, large national banks and bank holding companies, as well as multi-state superregional banks, are the promoters and definite winners of sectoral reform. The number of small banks is declining and their ability to shape sectoral change is waning. In Germany, centralized universal banks managed to reorganize the domestic financial marketplace according to the international standards of the hegemonic model, impose additional costs for raising regulatory standards on regional exchanges and the states, and bolster further the main exchange in Frankfurt.

The balance of power among different levels of the state is shifting as well. The federal government has gained power vis-à-vis the states in both countries because it is where national solutions to problems of global competitiveness are being provided. Even in the United States, where federal legislators have largely failed to provide these solutions, federal administrative discretion, supported by court decisions, has allowed piecemeal but cumulatively substantial sectoral reform. Federal regulators also are gaining over state authorities because an ever-larger portion of the banking industry is coming under the jurisdiction of the former. Moreover, the German case demonstrates that the federal state gains power within the federalist regulatory setting because it is the linchpin to the international community of financial market regulators where regulatory frameworks are being harmonized and the global playing field is being negotiated. In sum, we see centralization in regulatory authority and market structure as causally linked—each reinforces the other.

Centralization in financial federalism reflects the growing challenge to state (and market) actors to reconcile or make compatible domestic financial policy and regulatory structures with the minimum requirements of international financial markets (on this approach, see also Katzenstein, 1978). This is true even for those states that may play a major role in defining those international requirements. There is no single hegemonic state actor in this arena. There are, however, emerging hegemonic sectoral models. In banking, this model is essentially universal banking, with an emphasis on strict prudential regulation. In securities markets, this model is largely Anglo-Saxon (and especially American) in nature, with a regulatory emphasis on market transparency (investor protection). Although both of our countries were facing the need to meet these minimum requirements if they were to remain internationally competitive, both of them took substantially different institutional paths of adaptation. Because the particular institutional character of financial federalism of each country differs in crucial ways and therefore offers different

types of vulnerabilities to the emerging international market pressures, different patterns of sectoral reform became visible.

In the United States, it was the competitive character of federalism, linked with a highly pluralist, fragmented legislative system, that partially blocked and refracted the growing pressure toward universalization of financial services. Lowering profit margins in commercial banking was the foremost reason why domestic banks started lobbying for desegmentation on the state level. Because state regulators were eager to attract new banking firms to their local territories, a deregulatory competition among states evolved that allowed incremental progress toward universalization. However, decentralized competition did not lead to a complete elimination of territorial and functional market barriers in the United States. This regulatory “race to the bottom” was usually stopped in Congress, where coalitions of “market losers” managed to block legislative change (Reinicke, 1995). Because the U.S. legislative system provides a large number of veto points (on veto points, see Immergut, 1992), deregulatory decisions were not necessarily triggering broader legislative reforms, as the numerous unsuccessful attempts to repeal Glass-Steagall indicate. Since the mid-1980s, however, the issue of domestic regulatory reform has been linked with concerns for the decreasing international competitiveness of U.S. banks and new threats to systemic stability. It is for this reason that federal regulators, particularly the Federal Reserve Board, started playing a more active role in the regulatory game. Supported by a growing, although heterogeneous, prorepeal coalition among the financial services industry, federal regulators began to allow commercial banks limited investment banking activities. Even without repeal of Glass-Steagall, the mixture of intense competition among markets actors and competition among the federal regulators that oversee these actors will continue to push the universalization of banking activities forward.

In contrast to U.S. competitive federalism, German federalism places greater emphasis on intergovernmental bargaining than on (regulatory) competition. In the securities sector, it was exactly the federalist consensus not to intervene in stock exchange matters that proved to be extremely vulnerable to the growing importance of transparency in matters of investor protection. Much more directly than the United States, Germany was confronted with the pressures that structural changes in international financial markets imposed on domestic actors.¹⁰ German universal banks faced pressure to recast the domestic rules that governed equity trading according to the evolving

10. The greater role of international pressures in the German case also is due to the fact that securities markets are generally more internationally integrated than banking markets (see Coleman, 1996).

hegemonic model of sectoral governance. This, in turn, challenged the formerly quite stable federalist model of horizontal power sharing: First, a model of self-regulation under the auspices of a conglomerate of German states was not trusted by foreign investors, and second, participation in the evolving interstate collaboration in matters of securities regulation required that member states had legal procedures for cross-border investigations. Therefore, meeting the requirements of the hegemonic sectoral model meant for Germany to clarify regulatory competencies and to create a trustworthy institution that made use of public law to provide for market and rule transparency. To be sure, the outcome of the turf battles between the federal government and the states still remains a complex regulatory structure that divides authority between them. Nevertheless, the German federal government was successful in using a divide-and-conquer strategy to win policy battles and, for the first time in sectoral history, gained substantial regulatory competencies in the system of sectoral oversight.

In both countries, the reorganization of financial federalism was driven by coalitions of globally oriented players, representing market and state interests, and the federal state increased its role in the sectoral system of oversight. The German case illustrates that the federal state is back again by ensuring transparency, fairness, and access to markets through legal penalties for non-compliance. In the United States, the widened role of federal regulators is, first, due to the fact that they enjoy considerable administrative discretion in order to enact regulatory change while bypassing the legislative arena. Second, concentration processes in the U.S. market are enlarging the regulatory turf of the federal state. Third, and most important for the further development of banking regulation in the United States, the elimination of market barriers is accompanied by rising standards of protection against the risks of banking failures. Similar to what is to be observed in Germany, federal regulators become increasingly in charge of monitoring and enforcing higher standards of both risk and investor protection.¹¹

At this point, one might question whether our general conclusions regarding convergence and centralization are unique to the financial sector. A brief examination of other studies suggests that there is broader, although not unequivocal, support for the general argument that increased domestic and international market competition/integration promotes convergence and centralization in regulatory competence. David Vogel's (1995, 1997) study of

11. This is even more true with the increasing use of flexible and risk-oriented models of banking regulation that generally require a permanent monitoring role for supervisory agencies that goes beyond former practices of "one-shot-supervision" (see Litan & Rauch, 1998, pp. 139-149; Lütz, 1999).

automobile emissions regulations suggests that states within a federal system may, in fact, enhance their influence and regulatory competencies. His study convincingly shows that interstate competition within the system of U.S. federalism served to promote the ratcheting up of automobile emission standards, which were then adopted by the federal government. Vogel's so-called California effect holds true under the condition that the state that exports the high regulatory model is of a considerable size and has a large domestic market; if trading partners are seeking to maintain or widen their export markets, they are forced to meet those standards. Our findings suggest, however, that in the financial sector, the expansion of market incentives triggered more of a race to the bottom because interstate competition for financial producers considerably pushed the elimination of territorial market barriers, that is, deregulation. Second, the resulting concentration in the financial sector means that universalized financial firms are increasingly falling under the jurisdiction of federal regulators: Decentralized regulatory competition thus ultimately served to strengthen the federal government. Finally, (de)regulatory competition has raised the need for coordination among federal regulators because universal banking entailed higher risks for the stability of the whole financial system. The contrasting findings of our own and Vogel's study suggests that, at least in some sectors in which certain conditions apply, regulatory federalism may be strengthened in spite of economic internationalization. Further studies are needed to determine just how frequently such conditions might apply.

In contrast, a growing literature on regulation in Europe suggests, more in line with our argument, that the central level has gained statutory competencies over business, notably in those economic sectors that have undergone processes of deregulation and privatization: Britain and France in particular have created new central regulatory bodies in sectors such as telecommunications, water services, electricity, and broadcasting, mainly to promote competition in industries that have lost their former monopoly status and are now open to domestic and international competition (König & Benz, 1997; Majone, 1994, p. 63; 1996). For Germany, Dyson (1992) and Werle (1999) provide further evidence for our argument that processes of economic convergence and internationalization are likely to undermine federalist systems of regulatory power sharing. Dyson's (1992) study of the German broadcasting industry shows that the technological overlap of the broadcasting sector with telecommunications and publishing, combined with increased exposure to international competition, tends to undermine the decentralized oversight structure in German broadcasting. Similarly, Werle's (1999) study of the German telecoms sector argues that convergence of telecommunications and electronic media creates incentives for increasing coordination between the

German states and the newly founded federal regulator for telecom services (pp. 110-111).

In sum, there is considerable evidence that economic internationalization tends to promote a strengthening of central state regulation and thus a weakening of regulatory federalism across numerous sectors of the economy. Our study suggests two particular reasons for why this appears to be the case: First, in many sectors, increased internationalization requires, or at least creates powerful incentives for, increased international regulatory cooperation; for various reasons, this requirement is generally best met through central state action. This proposition appears most compelling for sectors, such as finance and telecoms, that are highly dependent on a global technological infrastructure in which a market failure in one country immediately affects markets and market actors in others. Second, internationalization favors market and political actors who are globally oriented and generally prefer uniformity in regulation across the diverse geographical markets in which they operate. Achieving such uniformity does not necessarily require centralization of regulation within countries but it is generally easier to achieve through national regulation rather than through regulatory harmonization among sub-national governments.

In contrast to the commonly held view that internationalization weakens political control over business, our study suggests further that although states in federal systems may frequently lose some of the control that came through regulatory powers, central governments do not necessarily lose control or influence over market actors (see also the volume by Smith, Solinger, & Topik, 1999, for this general argument). Indeed, in the securities industry, internationalization requires a high level of state regulation, as shown in the German example. For advocates of federalism, these findings are not comforting. However, there is ample evidence that even in a more globalized economy federal systems are a robust form of government and that sub-national governments can still find means to influence market actors (e.g., Deeg, 1996; Saxenian, 1994).

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