Internationalization and Financial Federalism – The United States and Germany at the Crossroads?

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98/7

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MPIfG Discussion Paper 98/7
ISSN 0944–2073
September 1998

Abstract

In this paper we 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, we analyze changes in financial regulation and market structures in Germany and the United States. Our 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. Our 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. While both the German type of cooperative federalism and the American model of competitive federalism proved to be "vulnerable" to the growing international pressures, the two countries took different paths of change that reflect differences in domestic institutions. Thus we conclude that convergence is, and will likely remain, of a limited nature.

Zusammenfassung

Dieser Beitrag untersucht die Effekte ökonomischer Internationalisierung auf Staatsstrukturen und auf die Machtverteilung zwischen verschiedenen Ebenen föderaler Systeme. Mit Hilfe einer Rational-choice-Perspektive des institutionellen Handelns werden Veränderungen in Struktur und Regulierung nationaler Finanzmärkte am Beispiel Deutschlands und den Vereinigten Staaten behandelt. In beiden Ländern unterliegt der Finanzsektor erheblichem Internationalisierungsdruck und ist gleichzeitig durch eine ausgeprägt föderale Struktur gekennzeichnet. Unsere Ergebnisse verweisen auf beträchtliche Konvergenz von Marktstrukturen und Regulierungsmodi in beiden Ländern, welche mit der Zentralisierung von Regulierungskompetenzen auf der Bundesebene verbunden ist. Sowohl der deutsche „kooperative Föderalismus" als auch das amerikanische Modell des „Wettbewerbsföderalismus" erweisen sich also als „anfällig" gegenüber wachsendem Internationalisierungsdruck, dennoch schlagen beide Länder unterschiedliche Reformpfade ein, welche Ausdruck des jeweiligen nationalen Institutionengefüges sind. Die Dynamik von Konvergenzprozessen wird (wohl auch zukünftig) institutionell eingedämmt.

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1 Introduction

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 actions of national governments and by the development of multinational corporations, which tend to diversify their operations on a worldwide scale (Kapstein 1994; Helleiner 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 multilateral negotiations. While the Single Market Program of the European Union is the most prominent example of the growth of supranational efforts in market integration, international "regimes" (Krasner 1983), like the *Basle Committee* in banking (see Kapstein 1994) or the *International Organization of Securities Commissions,* or 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 experienced 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

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A former version of this paper was presented at the 1996 Annual Meeting of the American Political Science Association, San Francisco, August 29–September 1, 1996. We are indebted to Bill Coleman, Ulrich Glassmann, Marc Smyrl and two anonymous reviewers from *Comparative Political Studies* for helpful comments. Special thanks are due to Bruno Egger and Markus Burtscheidt, whose technical assistance has made our transatlantic cooperation possible.

financial governance. By financial governance we refer to the set of institutions (whether public or private), and the relationships among them, which 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 which has been characterized by 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, 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 sub-state, lines. While there have long been money-center banks operating on a national and international level, the vast majority of American banks operated in rather small (geographically) 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, like the U.S., a 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 paper is twofold: *firstly*, 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 Keohane/Milner (1996) and Frieden/Rogowski (1996), we assume that domestic actors' policy preferences are derived largely from the market incentives they face.[1] Our findings in-

1 While 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.

dicate 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 will later 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.

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") (Sobel 1994; Gourevitch 1996). Our findings suggest 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 either 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, *secondly*, the evermore popular convergence question, i.e. 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? Compare Berger / Dore (1996); Unger / van Waarden (1995); Crouch / Streeck (1997); Goldthorpe (1984).

We argue first that those states which 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. 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 Moran 1991; Coleman 1996; Lütz 1998). This model emphasizes low restrictions on product and market inno-

vation but high investor or consumer protection under strict state oversight (as opposed to frequently opaque self-regulation). In banking markets, the universal banking model, of which Germany is a prime example (on this model see Deeg 1998), is hegemonic. In this model financial institutions face few restrictions in their activity and 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 U.S., convergence towards centralization (including harmonized regulation) and a stronger federal role is being filtered by the distinctive institutional framework each of the two political systems provides. Obviously, there is still considerable scope for significant differences to remain across nations. We therefore provide in this paper much-needed empirical evidence that supports a middle ground position in the debate between those who argue in favor of convergence (Goodman / Pauly 1993; Andrews 1994; Keohane / Milner 1996) and those more apt to reject it (Wade 1996; Perez 1995; Garrett 1995; Vogel 1996).

Section 2 describes the models of financial federalism as they governed the United States and Germany up to the 1970s (Section 2). Section 3 highlights the most distinctive global market changes and their implications for the power relationships within domestic systems of financial federalism. Afterwards, the process of centralization in each federalist system is described and linked with the changing preferences and strategies of domestic actors (Section 4). Finally, transformation processes in both countries are compared and differences in convergence analyzed (Section 5).

2 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 which 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, since policies are coordinated mostly between federal state bodies and peak associations, a corporatist type of sharing regulatory powers between public and private actors prevails (see also Coleman 1996: 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 which 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 which 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, as 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 non-intervention. This policy was continued after the Second World War, when eight regional stock exchanges were re-established and the Stock Exchange Legislation became part of Art. 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 Wertpapier-*

fragen) where ministers and government officials of the state finance or economics ministries were represented. In cases which 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 since 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. Since it was primarily the large universal banks which 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 nor 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 government and the states 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]

2 This assertion is qualified by the fact that all state banks have a companion regulator

Consensus among the federal and state governments and stability in regulatory federalism were also 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 was also seen as part of this). Fragmentation in markets and regulation were accepted as tradeoffs 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 like 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: 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, 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 were also largely prohibited from engaging in insurance activities.

Tight restrictions on competition in the U.S. obviously reduced the need for prudential bank regulation since restrained competition was deemed to reduce the likelihood of insolvency. Regulations on asset allocation, capital adequacy (sol-

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at the federal level (either the Federal Reserve or FDIC) which 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: 23).

vency) and reserve deposits (liquidity) were not as formal or systemized as German prudential banking regulation. While capital adequacy regulation was important for all bank regulators in the U.S., no fixed, harmonized standards for measuring capital adequacy existed. Different regulatory authorities followed ad hoc rules and their best judgement in assessing bank solvency. While 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: 15)

There was no nationwide branch banking system in the German sense, i.e., 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 economic and political arrangement.

3 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 tradeable securities since 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, since they are increasingly bypassed by large customers and are left with smaller firms that are often less credit-worthy 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 like investment banking. Those commercial banks which 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

de-segmentation 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 importantly adequate capital reserves – in order to protect their customers against financial losses and 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 in order to ensure adequate transparency of market transactions. In such systems the pure type of investment banking business is more short-term oriented, since 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. Since 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, partially mismatched the new institutional requirements of international competition, that is, the combination of universal banking with well-developed and transparent securities markets. The American 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 SEC (*Securities and Exchange Commission*). 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, overseen by a federal supervisory agency and the Bundesbank. In Germany, it was the stock exchange sector which did not meet the requirements of the new hegemonic financial model: securities markets were underdeveloped and so was the system of sectoral regulation. Regional self-regulation governed trading activities and producers defined the degree of market transparency while investors were excluded from the self-regulatory system. Therefore, both countries had to solve different problems of institutional adjustment in order to meet the minimum requirements of global markets: While 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 System[4]

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 increasingly borrowing directly from capital markets, especially foreign. These firms were also increasingly passing over domestic banks in favor of foreign investment banks (Deeg 1998). Second, large universal banks, for all their size and prowess at home, needed to catch up in international competition and especially to launch an offensive 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 in order 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 in order 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 in order 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 offer DM contracts, and Deutsche Mark securities markets grew outside of the country, with the center of the Euro-DM market being in London, followed by Luxembourg and Paris.

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

There are 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 while 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. Additionally, 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. Securities and Exchange Commission, however, prohibited trading of these products in the United States by arguing that they came from a market which operated under lower regulatory standards than the U.S. Since 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 enjoyed 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. In order 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 distinct pressures to reorganize the domestic securities industry. These pressures evolved out of the growing interstate coordination on issues of financial regulation that emerged during the 1980s. 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 have until recently been the predominant form of regulatory coordination in the securities sector (see Bernhard / Blumrosen 1993; Baumgardner 1990). 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.

Most important for Germany, multilateral coordination on matters of securities regulation has been promoted within the European Union. The EU's Single Market Program of 1985 considerably pushed the integration of European capital markets. Some of the most important EU initiatives are the directives on "Insider Trading" (89/592/EEC of November 13, 1989) and on "Investment Services" (93/22/EEC of May 10, 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 which can cooperate closely with its foreign counterparts. 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).

Against this background of an evolving global network of interstate collaboration, the German Federal Ministry of Finance felt Germany was losing influence over the evolving terms of international competition and therefore falling behind its competitors. For example, Germany was excluded from the circle of bilateral exchanges since 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 only public regulatory bodies are allowed to participate in the core decision-making process. Since 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 American 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. The deregulatory process in the U.S. was also driven by the need to respond to some unintended consequences of earlier deregulatory reforms. The Savings & Loans 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. While these domestic factors can explain a great deal of the regulatory reform in the U.S. 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 U.S. is driven by both domestic and foreign market actors (compare Reinicke 1995: 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 Fed, and the Treasury have all consistently argued for repeal by invoking the international competitiveness issue. This was not simply rhetoric, as the growth in competitive pressures from foreign markets and financial institutions is quite real. Thus change in the U.S. has been driven by a comparatively complex mix of domestic and international factors.

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, e.g., in money market mutual funds offered by securities houses. Some banks, especially Savings & Loans, 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: 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 U.S. (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 U.S. 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: 23–24). In 1991, foreign banks accounted for 45% of commercial loan volume in the U.S. (Herring / Litan 1995: 18). The long preeminent position of American 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 in order to circumvent domestic barriers to broader financial activities (and remain competitive abroad). The efforts of the European Union to integrate its financial market in the 1980s 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 U.S. Thus if European banks could not act as universal banks in the U.S., then neither would U.S. banks be able to compete as universal banks in Europe – a market largely dominated by universal banks. Since 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.

4 The New Models in the United States and in Germany – Towards 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), while German actors raised the standard of investor protection in the securities sector (reregulation). But both countries took the same direction of institutional change towards 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] Though 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 European Union's Insider-Trading and Investment Services Directives into German law, the manner in which it was to be implemented was not pregiven and involved considerable political maneuvering. The coalition of global players strongly preferred a federal (centrist) solution to the oversight problem, modeled on the United States' Securities and Exchange Commission. 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 Hesse (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, Hesse 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 Hesse got further authority to supervise the exchange actively (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.

Hesse's actions were important because they put additional pressure for a centralized reform solution not only on the Federal Ministry, but also on the other German states. Although the other states realized that Hesse had broken ranks with them, most opted not to follow Hesse's move and thereby maintain some

5 This section draws heavily on Lütz 1998.

sort of competitive parity between their own exchanges and Frankfurt. Since 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 since 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 one year before the globally-oriented coalition emerged as the winner. A new regulatory model was decided upon 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 since formerly self-regulated matters became the subject of federal supervision or were now regulated in public law. The exchanges were required to set up a new body for supervising stock exchange trading (*Handelsüberwachungsstelle*) whose task is 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 et al. 1976).

Regulatory practice has shown that direct contacts between the federal level and the stock exchange level prevail while, at least in some German states, regulatory supervision is more of symbolic character. This is not surprising since the states were left with their second-best option – they gained some formal regulatory powers, but at the same time they have to bear the respective costs for increased regulation. Since most German states are suffering from severe budget restraints, they cannot take their regulatory duties too seriously. The likely scenario will therefore be that the majority of states will continue to lose power in the new regulatory setting. Moreover, the Frankfurt exchange intends to supplant the re-

gional trading floors with an electronic trading network. If this strategic concept becomes reality, there will no longer be even the slightest reason for upholding the already weakened federalist structure of regulation. Taken together, it is quite obvious 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 which has driven the process of lowering geographical and functional market barriers, i.e., 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, which 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 six-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. While 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 were also "leveraging effects" at work since 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: 1075–1077). Federal government actors also became enthusiastic about interstate banking because, in an increas-

ingly 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 (Hammond / Knott 1988: 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 superceded 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: 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).[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: 2–5). With the continuing consolidation of major regional commercial banks the U.S. 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. While state banks may also branch across state lines, they are at a comparative disadvantage since 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 and thus federal regulators can apply more or less the same regulations to all branches of multi-state national banks. States are therefore confronted with the threat that state banks will convert to a national bank charter in order to expand their business more

6 Rhoades (1996: 9). Rhoades provides an extensive analysis of US bank industry mergers between 1980 and 1994.

easily (Eager 1995).[7] In order 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 U.S. 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 nearly 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.

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). While 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 which broadened their commercial banking activities.

The clamor for repeal of Glass-Steagall swelled in the mid-1980s when the crisis of the American banking system was turned into a matter of vital national interest. Sharpened competition from foreign banks in the U.S. and threats from the European Union to reduce opportunities for U.S. banks in Europe allowed the pro-repeal 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 American and foreign banks. All these changes greatly concerned the New York financial community

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).

and the Fed. Increasingly Glass-Steagall appeared as a "Maginot Line" (Reinicke 1995: 94–96). By 1987 the pro-repeal 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 Savings & Loans 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. The pro-repeal 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 in order to compete with emerging financial conglomerates. The pro-repeal coalition continues to argue that repeal of Glass-Steagall will benefit domestic consumers and businesses and is vital to maintaining the international competitiveness of U.S. financial firms. The only remaining visible opponents are 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. Though the structure of the American 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 differences among the pro-repeal groups over what the new rules of competition should be. On one side, the securities and insurance industries and the Fed are pushing for a financial services holding company model to be the favored corporate form. On the other side, much of the banking industry and the Treasury are pushing for a simpler corporate banking model which would give the OCC a greater regulatory role, as opposed to the Fed.

Congressional failures once again 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 link-ups between commercial banking and securities firms, and even insurance. 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 have also begun permitting insurance companies to enter into banking activities. Thus, whether Congress acts or not, the barriers between investment and commercial banking will continue to come down – and apparently at an ever faster rate. Declining business in traditional commercial banking activities and growing competition – including from deep-pocketed foreign banks intent upon 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 which, 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 ensuring individual bank and systemic stability. 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 in order to prevent competitive disadvantages for American banks (Reinicke 1995: 135–150).

5 Internationalization and the Different "Vulnerabilities" of Financial Federalism

Both the German type of cooperative federalism and the U.S. model of competitive federalism proved to be "vulnerable" to the pressures that structural changes in financial markets imposed on them. In both systems of financial federalism,

power shifted toward those actors which, 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 that were eager to expand their business lines functionally and geographically in order to meet international standards of competition which actively engaged in sectoral restructuring and disrupted the historic equilibrium in each country's financial federalism. In the U.S., large national banks and bank holding companies, as well as multistate 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 U.S., 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 are also 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 U.S.) in nature, with a regulatory emphasis on market transparency (investor protection). While both of our two 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. Since 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.[8]

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 towards universalization of financial services. Decreasing profit margins in commercial banking were the foremost reason why domestic banks started lobbying for desegmentation on the state level. Since state regulators were eager to attract new banking firms to their local territories, a deregulatory competition among states evolved that allowed incremental progress towards universalization. However, decentralized competition did not lead to a complete elimination of territorial and functional market barriers in the U.S. This regulatory "race to the bottom" was usually stopped in Congress where coalitions of "market losers" managed to block legislative change (Reinicke 1995). Since the American legislative system provides a large number of veto points (on veto points see Immergut 1992), de-regulatory 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 pro-repeal coalition among the financial services industry, federal regulators used their administrative discretion to allow commercial banks limited investment banking activities. Although competition among states and among financial lobby groups will continue to reduce the capacity for comprehensive legislative reform in the United States, federal regulators are likely to push the universalization of banking activities forward.

In contrast to American "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 into 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 U.S., Germany was confronted with the pressures that structural changes in international financial markets imposed on domestic actors. German universal banks faced pressure to recast the domestic rules that governed equity trading according to the evolving "hegemonic" model of sectoral governance. This, in turn, challenged the formerly quite stable federalist model of hori-

8 We are indebted to Fritz Scharpf for the idea that domestic institutions provide different types of "vulnerabilities" to international pressures.

zontal power-sharing: first of all, a model of self-regulation under the auspices of a "conglomerate of German states" was not trusted by foreign investors. And secondly, 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 competences and to create a trustworthy institution that made use of public law in order 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 which 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 competences 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 of 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 American market are enlarging the regulatory turf of the federal state. Third, and most important for the further development of banking regulation in the U.S., is that 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.

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, though 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 study of automobile emissions regulations suggests that states within a federal system may, in fact, enhance their influence and regulatory competences. His study convincingly shows that interstate competition within the system of American federalism served to promote the ratcheting up of automobile emissions standards, which were then adopted by the federal government. Vogel's so-called "California effect" holds true under the condition that the state which 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 (D. Vogel 1995, 1997). Our findings suggest, however, that in the financial sector the expansion of market incentives triggered more of a "race to the bottom" since interstate competition for financial producers considerably pushed the elimination of territorial market barriers, i.e. 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 since 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 competences 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 like 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 (Majone 1994: 63, 1996; see also König / Benz 1997). For Germany, Dyson (1992) and Werle (1998) 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 study (1992) 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 threaten the decentralized oversight structure in German broadcasting. Similarly, Werle's 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 (1998: 10–11).

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 and, for various reasons, this requirement is generally best met through central state action. Second, internationalization favors market and political actors who are globally oriented and

generally prefer central state regulation and uniformity in regulation across the diverse geographical markets in which they operate. In contrast to the commonly held view that internationalization weakens political control over business, our study suggests that, while 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. 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 subnational goverments can still find means to influence market actors (for example, Deeg 1996; Saxenian 1994).

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