

The Domestic Politics of Banking Regulation

Frances Rosenbluth (Yale University)

and

Ross Schaap (UCLA)

April 2002

Abstract

This paper seeks to ground financial regulatory choices in domestic politics. Based on evidence from 22 industrialized countries, we argue that electoral rules—specifically, the extent to which they are centrifugal or centripetal—have a significant effect on whether the banks or their consumers pay for the security of the banking system. Despite the homogenizing effects of global financial integration, moreover, the political dynamics generated by these electoral rules continue to shape the nature and extent of prudential regulations that countries adopt in the place of banking cartels.

This paper was prepared for presentation at the annual meetings of the American Political Science Association, held in San Francisco in September, 2001. We would like to thank B. Jerry Cohen, Louis Pauley, and other participants at our panel for helpful comments. We also thank Kathy Bawn, Stephan Bub, Tim Clark, Scott Desposato, Geoff Garrett, Akinari Horii, Takeo Hoshi, Banri Kaeda, Susanne Luetz, Rieko McCarthy, Yoshimasa Nishimura, Thomas Oatley, Frank Packer, Marc Saidenberg, Michael Thies, Sei Nakai, and a number of other bankers and officials for helpful suggestions and comments. We are grateful to Yoshiko Inoue, Jana Kunicova, Yuka Sumiya, Vineeta Yadav, and Mark Zimny for exceptional research assistance. Frances Rosenbluth thanks the Council on Foreign Relations for a fellowship to spend a year at the Federal Reserve Bank of New York (1999-2000). There were many people in the Bank whose help, of one kind or another, was indispensable.

1. Introduction

One of the most pressing theoretical questions of our times, and one that has far reaching practical implications as well, is whether, and to what extent, economies around the world are converging into a single pattern. We don't tackle that issue head on here, but instead examine closely one of the questions that underpins it: what makes national economies different in the first place? A logical place to start this inquiry is national banking regulation, given that finance has become one of the most globally integrated sectors in the world. Banking therefore represents a "hard case" for showing that national differences are systematic and resilient, at least in the interstices of global financial mobility and competition.

National banking regulation varies along more dimensions than we can capture easily in a book, let alone in a paper. Here, we focus on one we have found to have a surprising degree of power: a nation's electoral rules. The connection between electoral politics and banking may not seem obvious, particularly given the technical nature of banking and the seemingly apolitical and bureaucratic way in which banks are regulated in many countries. But upon reflection, we can see why politicians do care about banking at a very basic level: in good times, banks can be profitable businesses that make large campaign contributions; in bad times, bank failures can get politicians into electoral hot water. Like it or not, politicians are forced to make trade offs between the well-being of banks and of bank customers.

Electoral rules matter because they dictate what a politician must do to get elected. In this paper, we want to draw a causal line from these electoral incentives all the way to government choices over banking regulation and the impact of that regulation on market structure and pricing of banking services. We find ourselves in the company of a few, but

growing number of scholars who are exploring the policy consequences of electoral rules. Rogowski (1987) argued that proportional electoral systems made it possible for small European states to remain more open to trade because of the strong party discipline and central that such rules foster. Carey and Shugart (1995) suggest that the presence or absence of intra-party competition engendered by electoral rules is key to a country's ability to provide its subjects with public goods. Proportional systems exhibit higher levels of government expenditures (Persson and Tabellini 2000), larger budget deficits (Roubini and Sachs 1989), and greater income equality (Birchfield and Crepez 1998; Austen-Smith 2000). McGillivray (2001) shows that majority parties with strong party discipline in single member district systems are more likely to pay off voters in marginal districts with fiscal largesse, whereas governments in proportional systems are more likely to pay off districts loyal to the parties in power. Quinn and Inlan (1997) and Bernhard and Leblang (1999) assume that majoritarian systems, where a small number of votes can lead to large swings in the distribution of legislative seats, give governments a stronger incentive to maintain control over policy instruments that may help to secure their electoral majority. In a similar vein, Rogowski and Kayser (2001) argue that the greater seat-vote elasticities of majoritarian electoral systems induce politicians to keep consumer prices lower than in proportional representation systems.

In understanding banking regulation, we find it more productive to focus on a single discernible difference in the way electoral rules motivate politicians: whether they force politicians to go after the median voter, or whether they encourage politicians to go after groups of voters. Single member districts (SMD) are, all else equal, centripetal in their effect, as Anthony Downs's classic work argued. But this is just one possible choice of electoral rules.

Various types of proportional representation (PR) systems are, to one degree or another, centrifugal.

We examine some broad indicators from 23 industrialized democracies for evidence that this aspect of electoral rules affect banking outcomes, and find that it does. To check our argument, we take a closer look at four strikingly different financial powers: the U.K., the U.S., Germany, and Japan. Despite the widespread adoption of Basel Accord prudential rules, these countries still employ a variety of other regulatory tools that affect the competitiveness of domestic banking. Japan gives us the greatest leverage on this question, because its change of electoral rules in 1994 provides a sort of natural experiment where we can observe directly the effects of our primary independent variable on banking regulation.

The rest of the paper is organized as follows. Section 2 shows how banking differs from most other sectors of the economy in the extent and magnitude of potential market failures that require regulatory attention. Section 3 examines the political reasons for the trade-offs governments make in choosing among types of banking regulation. Section 4 undertakes several statistical tests of our proposition that governments in centripetal systems are more likely to force banks, rather than consumers of banking services, to pay for financial system stability. Section 5 takes the empirical examination to a micro level to check the logic of our argument in four specific national contexts. Section 6 concludes.

2. How Banking is “Special”

The alchemists had it wrong: you can’t make gold out of base metals. But as any banker knows, making money in the banking business hinges on a few intangibles that can seem almost as magical and mysterious: information and judgment about credit risks, depositors’ trust in the bank, and the time value of money. With the right ingredients, banks can transform savers’

short-term deposits into long term loans, pay interest on the depositors' savings, and make money to boot. But if bankers make too many bad loans, or even if depositors only suspect that they have, depositors may rush to retrieve their savings. Because maturity transformation doesn't work in reverse—you can't short term pay accounts payable with long term accounts receivable—the whole banking system can choke up in a massive liquidity crunch in a single afternoon. If that elusive trust of savers evaporates, regulators have a liquidity crisis on their hands, or worse. Even healthy banks can fail under panic conditions (Diamond and Dybvig 1983).

Asymmetry of information and the fragility of trust constitute a colossal market failure waiting to happen. Depositors' relative lack of information about what banks do with their money gives bankers an incentive to make riskier loans. This is because the upside gains from risky loans are potentially large while the limited liability of shares reduces downside risk (Merton 1977). Of course, depositors generally do not need to worry about such matters because deposit insurance places the moral hazard of this situation squarely on the shoulders of government.

The banking industry cries out for public intervention of one sort or another. In the absence of deposit insurance a suboptimal allocation of capital will arise as wary savers stuff their cash into mattress covers. If the government has extended deposit insurance, prudential regulation is required to forestall, or at least limit, the potential downside for the government. The problem for regulators is that there is no single optimal way to regulate banking (Bhattacharya and Thakor, 1993:31). In the absence of deposit insurance, requiring strict disclosure, at a minimum, would force banks to pay depositors a rate that matches the riskiness

of the bank's loan portfolio. But discriminating among banks is likely to be costly for the average saver. Trying to protect depositors with mandatory deposit insurance, on the other hand, creates moral hazard all over again because such schemes tend not to be related to risk. With fixed insurance premia, the value of insurance increases with the riskiness of the loans. A bank can potentially make higher profits on riskier loans, but if, in the worst case scenario, the loans are not repaid and the bank fails, the deposit insurer will pay the depositors. As we saw from the U.S. S&L fiasco in the early 1980s, banks that are already in financial trouble can be tempted to "gamble for resurrection" provided that deposit insurance limits their liability to depositors (Fратиanni, 1995: 148-149).

Mandatory disclosure and insurance are at the minimalist end of the regulatory spectrum and figure prominently in economics textbooks concerned with efficiency. In the next section, we explore the range of banking rules from minimalist to highly interventionist.

2.1. Types of Financial Regulation

As a practical matter, banking systems of the industrialized world cluster roughly into two types. **Prudential** regulation imposes the costs of system stability on the financial institutions themselves, by, for example, forcing banks to hold reserves as a cushion against bad loans and to limit loans to some specified multiple of paid-in capital.¹

Profit padding regulation, on the other hand, foists the costs of system stability with taxpayers and consumers of financial services, by limiting the competition among financial institutions. Whereas prudential regulation may coexist along with or in the absence of market

¹ Milne and Whalley (1998: 8) describe capital as "a form of self-insurance against poor asset returns, with the bank retaining earnings in order to build up capital reserves towards a desired level and so reduce the probability of losing ownership of the future profit stream."

competition, profit padding requires that financial institutions not compete away their profits. Borrowers pay more for loans, depositors get less money on their deposits, and taxpayers stand ready to bail out ailing institutions. In exchange, depositors enjoy safety (think of below-market interest rates on savings accounts as a hefty insurance premium that they pay for that safety) and bank employees are more likely to keep their jobs over the long run.

Profit padding works because that very profitability disinclines banks to take undue risks. In fact, three influential economists suggest in a recent article that profit-padding may serve as a prudential regulation in just this way (Hellmann, Murdock, and Stiglitz, 2000: 148). Too *much* competition, they argue, inclines banks to gamble because lower profits shorten the time horizons of bank owners and managers. Better, they argue, to set interest rates so as to ensure bank profitability, thereby giving banks an incentive to stay out of trouble. Profit padding can promote financial system stability and in this sense appears to be, and indeed functions as, prudential in nature. In this paper we put the term “prudential” to a different use than these authors. We are not evaluating systems for their relative safety, but determining who must absorb the costs of securing financial system stability.

Figure 1: Competition and Prudential Outcomes, Expected Outcomes

Prudential Regulation	High	I. Excessive Protection	II. Competitive Regulatory Environment
	Low	III. Profit-Padding Regulation	IV. Moral Hazard Danger
		Low	High
		Level of Competition	

The two dimensions in this figure, prudential regulation or its absence, and competition or its absence, are hypothetically distinct. It's easy to see why, in practice, most banking systems cluster in quadrants II and III. The first quadrant, where strong prudential regulation coexists with low levels of competition, imposes unnecessary political and economic costs, where both banks and bank consumers are paying for more security than is necessary. Not surprisingly, this quadrant is typically empty.

Quadrant IV is also rarely occupied, at least for long. Governments choosing to shore up banking system safety with cartels rather than with prudential regulation must limit competition, if they can. A country that finds itself in quadrant IV, where low levels of prudential regulation coexists with strong banking competition, is in an extremely uncomfortable situation where the stability of the nation's banking system is in danger. The government has the choice, at that point, to try to limit financial competition, or to adopt stronger prudential rules.

Because of the inherent trade-offs involved, there are theoretical grounds to justify or impugn almost any banking regulatory system. Our argument is that governments adopt any

given combination of rules on account of distributive political concerns rather than from calculations of economic efficiency. In the next section, we explore the political variables that shape the choices over banking rules, how institutions affect levels of competition. In the final sections we will take the next step by illustrating with case studies how out competition corresponds to different levels of prudential regulation.

3. Banking Regulation and Domestic Politics

Government regulators can be counted on to mix political objectives with efficiency concerns anyway, but the absence of a textbook blueprint for optimal banking rules makes for a rich assortment of domestic banking structures, worldwide. There are numerous ways to guard against bank runs, and the trade-offs that regulators make in choosing one type over another have important consequences for groups of domestic constituents. This section explores how domestic politics in industrialized democracies shape those trade-offs.

Regulating the banking industry requires specialized knowledge of finance and corporate governance, and therefore democratic governments typically delegate the task to bureaucratic experts. That is not to say, however, that legislators don't care about the results. The political process is usually quite explicit about the policy boundaries within which the bureaucrats are to manage the banking sector. At a minimum, politicians want to avoid bank runs that rob voters of their savings, or more likely, to require the government to draw on deposit insurance. Such events could lead to voter wrath on a scale that would threaten the political life of legislators. Politicians will therefore be likely to err on the side of bank system safety, even at the expense of efficiency and the moral hazard problems that make economists cringe.

Politicians may also be inclined to use the banking system to promote other political goals, such as cheap financing for favored constituents or pet development projects or protecting labor. Politicians' incentives for how and how much to manipulate the banking industry are much like the incentives politicians face for how interventionist to be more generally. On the demand side, they depend on the collective action capabilities of banks, bank clients, and labor. On the supply side, politicians depend on how partisan preferences are aggregated by electoral rules and legislative institutions, and how they are implemented by the administrative process.²

All else equal, banks have a collective action advantage over the average depositor and we should expect regulation to mirror that by transferring wealth from depositors to banks (Stigler 1971; Peltzman 1975). At the pre-institutional level of analysis, we can expect variation in banking regulation depending on how well the corporate sector or labor can compete with banks for public favor based on their collective action capabilities. But there remains ample variation in the treatment of producers and consumers across countries, and it is this variation in the relative protection of producer interests that we address. Only by looking more closely at domestic political institutions can we learn the conditions under which the government will choose to subsidize the collective action costs of depositors and other poorly organized groups.

3.1. Political Institutions and their Policy Consequences

Political systems vary in myriad ways, but we focus here on the extent to which the electoral rules force politicians to pay attention to the mass of voters in the middle, rather than to organized groups. We argue that it is useful to look at the continuum of electoral systems between those that could be called centripetal, such as single member district (SMD)

² We are using the terms "demand" and "supply" here analogously, to refer to societal pressures on the one hand, and

majoritarian/plurality systems, on the one hand, to those that are centrifugal, such as PR systems, on the other.

To draw a causal connection between electoral rules and policy content, we have to show that parties in centripetal and centrifugal systems would aggregate the interests of an equivalent set of voters differently. Even with the same underlying distribution of preferences in society, politicians in centripetal systems have to build larger coalitions of voters in order to win elections than politicians in centrifugal systems. Centripetal system parties are motivated to de-emphasize differences within the large coalition, and stress instead issues that the mass of voters care about, at least somewhat.

Centrifugal system parties, by contrast, focus on narrower issues that intensely concern the group of voters they are cultivating. Politicians in centrifugal countries such as Japan under SNTV and Germany with its variant of PR, win representation by appealing to groups that do not themselves make up majorities. In those countries, politicians can more easily gain election by appealing to groups with the built-in collective action advantage of already being organized.³

Rogowski and Kayser (2001) have argued that centrifugal systems have, on average, higher consumer prices than centripetal systems because the higher seat-vote elasticity in centripetal systems forces politicians to care more about voters in the middle of the political spectrum. Because the median voter cares about consumer prices, politicians in centripetal systems have to keep them lower than politicians in centrifugal systems where there is a lower pay off in terms of legislative seats from appealing to the median voter.

on the other, the government's decision making apparatus that filters those demands. See Tirole and Laffont (1991: 1090).

³ Cox (1998) shows that there is a greater electoral payoff from voter mobilization in PR than in majoritarian systems.

While the Rogowski/Kayser model is compatible with our own findings, it is not as obvious as they suggest that policy outcomes should differ under the two systems, because post-election coalition governments in PR systems can be conceptualized as parallel to majority parties in centripetal systems. We therefore find it necessary to build on a different theoretical foundation. It remains for us to show why majority governments in centripetal systems are likely to aggregate interests differently than majority coalitions among centrifugal parties.

We leave it to work elsewhere to derive a formal model, but the crux of our argument is that political parties maximize their marginal product to their constituents' utility, rather than maximizing their constituents' utility per se.⁴ Because parties in centrifugal systems are smaller than parties in centripetal systems, moreover, we presume that they represent relatively more homogeneous interests than the large coalitions that form parties in majoritarian systems.⁵ These smaller parties that form coalitions in centrifugal systems should therefore strive for policy outcomes that bear most directly on their constituents' interests.

We don't pretend to solve the disputes that remain in the large and pre-consensual literature on coalition bargaining (for example, Baron and Ferejohn 1989; Laver and Schofield 1990; Strom 1993; Laver and Shepsle 1995; Martin and Stevenson 2000; Druckman 2001). For our argument to hold, we need only to assume that parties in coalition governments logroll among themselves in some way to achieve the interests that their respective constituents care most about. We are not surprised, as Powell (2000) points out, that retrospective voting models using macroeconomic indicators seem not to explain voting patterns well in centrifugal countries. Benefits from macroeconomic policies are harder to divvy out to coalition constituents. But we

⁴ Schwartz 1984. We are obligated to Kathleen Bawn for pointing this out.

also expect, and seem to find, that centrifugal systems tend to produce higher taxes and higher services that are indicative of cross-party logrolls.

3.2 Electoral Rules and Financial Regulation

Financial regulation, and the pricing of banking services that are the subject of this paper, give us an in depth look at one of the issues on which we expect to find differences between centrifugal and centripetal systems. If we are right, politicians in centrifugal systems will be more likely to behave like the classic Stiglerian regulators: regulation transfers income from consumers to producers of financial services. We expect the cost of financial services should be relatively high for the average consumer and for the government to ensure the safety of the financial system at least in part through the use of banking regulation that protects the banks from “excessive” competition. This is because centrifugal systems accentuate the value of organized groups to politicians. By contrast, centripetal systems force politicians to implement policies that matter to the mass of voters in the middle of the ideological spectrum. In these systems, we expect retail prices of banking services to be relatively low and for banks themselves pay for the stability of the financial system through a variety of prudential measures imposed on them.

In summary, we expect to find systematic differences in banking prices in centripetal and centrifugal electoral systems, because of the distinct politics of coalition building under the two sets of electoral rules. In centripetal systems, parties form economic policies with the interests of a large and necessarily heterogeneous pre-election coalition in mind. They therefore aim at policies that many voters care about, at least somewhat, such as keeping expenditures for taxes and other spending low. By contrast, governments in centrifugal systems are formed by a

⁵ Cox (1998) shows that there is a greater electoral payoff from mobilizing groups of voters in PR than in

number of parties that each attempt to meet the intense preferences of relatively homogenous constituents. Economic policies are more likely to aim at protecting income, such as profits and wages, with the equilibrium result that taxes and services tend to be higher in these countries. In section 4.2 below, we discuss in detail how we operationalize this conceptual difference across electoral systems.

4. Testing the Argument

We expect centripetal systems to enforce stronger prudential rules than in centrifugal systems, thereby forcing banks to pay for the safety of the financial system. In this section, we look first at some indicators of prudential regulation. Admittedly, we have these data for only a few countries. We therefore turn in the following subsection to an indirect measure of the effects of electoral incentives, that of banking competition, for which we have data from enough countries to run some statistical tests.

majoritarian systems.

4.1. Dependent Variable: Prudential Regulation

One reasonable measure of prudential rules is regulatory staff, because of the labor-intensity of monitoring the risk-taking behavior of banks. This is a crude measure, to be sure, because many countries do not break down personnel lists by segment of the financial market such as banking, securities, or insurance. But since we have no reason to believe that the number of personnel for banking should not correlate with the number of personnel overseeing the other sectors, we can live with this data insufficiency. Controlling for the number of institutions that regulators must monitor, the data come out the way we would expect, as Table 1 shows.

Table 1: Regulatory Staff as a Ratio of the Number of Financial Institutions

	UK	US	Japan	Germany
Regulatory Staff	1800	11772	655	1080
Ratio (staff per institution)	.89	1.13	.78 (in early 1990s)*⁶	0.28

Second, we have found variation in one aspect of deposit insurance systems (DIS) that speaks to the breadth of prudential regulation: the deposit insurance system premia charged to banks. We should find that premia are larger in countries that are more likely to favor consumer interests. In fact, DIS premia are quite low in Japan and Germany compared to the U.S. The UK represents a different regulatory choice, where the insurance premium is callable by financial

⁶ Japan's regulatory staff has been gradually increasing even as the number of regulated financial institutions has declined during the 1990s. By 1999 Japan's ratio of staff to institution had risen to 1.32.

regulators according to need. The UK system creates incentives for cross monitoring because banks will have an interest in keeping others from taking on risk that may end up costing them all.

Disclosure requirements constitute yet another form of prudential regulation. Countries with more stringent requirements should be those most interested in protecting ordinary consumers. As we would expect, disclosure is highest in the U.S., followed by the UK with Germany and Japan (until recently) trailing significantly.

4.2. Another Dependent Variable: Banking Competition

Because we expect electoral rules to make a difference in banking regulation, we turn in this section to see if, by extension, we see a corresponding difference in market structure and pricing as a result of those regulatory differences. As a proxy variable for this dependent variable, we look at **interest rate spreads**--the difference between lending and deposit rates--using data from the International Monetary Fund's publication *International Financial Statistics Yearbook* (International Monetary Fund 1986, 1999). Our expectation is that banks in profit-padding regimes generate higher revenues by paying less to depositors and getting more for loans than banks in prudential regimes.⁷

For lending rates, we use short- and medium-term private sector borrowing. These rates represent averages since, in most countries, they vary according to the creditworthiness of borrowers. Lending rates are, of course, a function of many factors including inflation, money supply, and the supply and demand for money.

⁷ Note an irony here, however. Because bank regulators are rarely able to control all aspects of competition, banks in profit-padding systems often fritter away their profits by trying to maximize market share. For this reason, we do not expect banks in profit-padding systems to have higher profits than their counterparts in prudential systems.

Deposit rates are those for demand deposits, though in some cases time deposits as well. We leave out “certificates of deposits,” which specify rates that vary deposit amounts with time requirements. Deposit rates are subject to the same factors as lending rates. In fact, in our data sample these correlate at 0.92. The mean of interest rate spread is 4.25 with a standard deviation of 2.23. Below we flesh out the independent and control variables and provide their summary statistics.

Table 2 bears out our expectation that countries with higher effective thresholds have smaller interest spreads because these electoral systems force politicians to cater to consumers. The UK and the U.S., both using single-member district electoral systems that produce centripetal incentives, have lower spreads on average than do Japan and Germany.

Table 2: Average Interest Rate Spreads from 1978 to 1998

	UK	US	Japan	Germany
Interest Rate Spread	1.68	2.29	2.99	5.64

4.3. The Independent and Control Variables

Effective Threshold: Our primary independent variable is effective threshold as described by Arend Lijphart (1994). This measure correlates at 0.93 with the centripetal-centrifugal dichotomy. It is constructed as the median between two other types of electoral thresholds, the first of which is the *threshold of exclusion*. This is the minimum vote share that must be received for a party to gain any representation. In some cases this figure is fixed, as it is at five percent in Germany and four percent in Italy. In other cases this minimum threshold is a function of the parameters of the electoral system. For example, Israel's parliament has its 120 members elected in a purely proportional nationwide district. As a consequence, the threshold of exclusion in Israel is $1/121$.

The second component of the effective threshold is the *threshold of representation*: the maximum vote share a party can receive and still not receive representation. In other words, this is the hypothetical worst-case scenario in which a party's votes are either slightly insufficient or are poorly distributed among districts such that it wins no seats. This measure acts as a proxy for the size that a group needs to be in order to gain autonomous representation. From the standpoint of political competitors, effective thresholds determine the vote share that must achieve in order to win. Higher effective thresholds, such as in single-member district electoral systems, force politicians to appeal to larger aggregations of groups or voters.

Consider the values this variable takes on in some real world situations. Hypothetically, a pure proportional representation (PR) electoral system will have an effective threshold equal to the inverse of the district magnitude plus one ($1/DM+1$), if there is only one electoral district as in the Netherlands, Israel and, in effect, Germany. If there is more than one PR district, the effective threshold is calculated as the median between the inverses of the district magnitude of

the largest and smallest districts. Some countries inflate the lower bound of this by establishing a threshold of exclusion that exceeds the lower bound generated by district magnitude. This is the case in Germany, where the threshold of exclusion is five percent.⁸ Each of these systems gives politicians centrifugal vote gathering incentives.

At the other extreme, centripetal systems such as single-member district (SMD) systems also have their effective threshold established by the district magnitude. Under SMD the threshold of exclusion, the minimum vote share necessary to win a seat, is 50% plus one vote. This is simply the inverse of the district magnitude plus one. The threshold of representation is more difficult to determine in this instance. To calculate the threshold of representation for a majoritarian institution requires an auxiliary assumption. We employ the floor that Lijphart uses to calculate the variable where four candidates compete for a single seat. In this case a perfectly split vote could result in a winner with as little as one vote over 20% of all votes cast.⁹ We code the effective thresholds of SMD countries as 35, the median between 20 and 50.

In addition to these two variables, we employ numerous of control variables to cull out the other systematic factors that give rise to variation in interest rate spreads. Some of these may affect only one side of the spread, either the supply (deposits) or demand (borrowing); nonetheless, they should have predictable effects. Table 2 below offers the summary statistics of the independent variables (our proposed causal variable and various controls).

⁸ In Germany the effective threshold is also five percent because that figure is both the threshold of exclusion and the threshold of representation.

⁹ This floor is, if anything too low because the effective number of candidates in most SMD competition is usually well below four.

Table 3: Summary statistics of the independent variables

Independent Variable	Number of Observations	Mean	Standard Deviation	Minimum	Maximum
Effective threshold	460	13.79	12.84	0.67	35.00
Gross National Product	448	8.04E+11	1.51E+12	4.78E+09	7.92E+12
Gross Domestic Savings	425	22.38	5.02	9.55	39.61
Gross National Product per capita	448	22836.58	9506.94	6672.71	50850.55
Inflation	460	6.62	7.90	-0.71	84.22
Government Budget Deficit as a Percent of GNP	415	-4.11	4.34	-23.211	9.35
Gross National Product Annual Growth Rate	447	2.53	2.32	-7.69	11.09
Government Debt as a Percent of GNP	275	42.85	28.88	0.88	129.58
Money Supply (M2)	200	61.32	28.00	17.07	143.76
Trade as a Percent of GNP	425	68.12	37.59	16.31	210.07

Gross National Product: We use this variable measured in constant 1995 US dollars, in order to estimate the relative size of the economies in the data set. Larger economies should have broad and deep markets that generate benefits from economies of scale. These efficiencies, in turn, should produce a mild negative association with interest rate spread.

Using constant 1995 US dollars presents a potential problem with skewing caused by very large economies such as the US and Japan. However, we have analyzed the data both with and without a natural log transformation of this variable and the results are effectively the same. Consequently, we report the data without transforming it here.

Gross National Product Per Capita: This variable is also calculated in constant 1995 US dollars, and assesses the relative wealth of the countries. We expect the sign to be slightly

negative for reasons similar to those above. Wealthier countries are likely to have open financial markets relative to other countries. This would produce lower interest rate spreads if wealthier constituents are able to demand higher deposit rates and/or lower lending rates because of their mobility across borders. Home banks would either have to forgo the lost business or respond to recapture lost business by matching the more competitive financial services offered elsewhere.

Gross Domestic Savings: Higher savings are expected to have a negative coefficient.

The logic is that a larger pool of savings, by increasing supply, will decrease the cost of borrowing as lenders have to induce demand by lowering the cost of money. Conversely, a smaller pool of savings will raise the price of money as borrowers would have to pay more for scarce capital.

Inflation: This variable is measured as the annual percent increase in consumer prices. Inflation increases risk for lenders because the future value of the money they lend may decline. Therefore, inflation should raise borrowing costs. But this should be offset by an increase in deposit costs. In fact, each of these should be affected by the size of the pool of available savings. We have no expectation for the coefficient on inflation.

Government Debt as a Percent of GNP: By soaking up a large share of savings, high levels of government debt should increase the deposit rate because it increases the demand for money. However, it should also increase the lending rate because it decreases the supply of money to lend. Because debt financing is important for governments with large outstanding debts, one might expect governments to shift some of the costs of servicing debt by protecting banks in their other endeavors. For this reason we expect this coefficient to be positive.

Government Budget Deficit as a Percent of GNP: A government budget deficit, like accumulated debt, will create demand for savings and decrease supply for lending. This control

variable will capture variation across time of governments' need for capital. Since this variable causes upward pressure on both ends of the dependent variable, we do not have an expectation for the sign on this control variable.

Gross National Product Annual Growth Rate: High growth promotes demand for borrowing which may increase the lending rate. Therefore the expected sign on this variable is positive. As for the previous control variable, this variable will capture variation in the demand for money over time. When an economy is growing one might expect higher demand for capital. This should push lending rates up compared to periods of little or no economic growth.

Money Supply: We define this variable as the availability of money and quasi-money (M2). Increasing the supply of money available for lending should decrease the lending rate. Consequently, this control variable is expected to have a negative coefficient. This variable suffers from so many missing observations that it decreases our sample size by nearly one-half. However, even with money supply there is adequate data to produce meaningful coefficients so we include it in one model to illustrate its predicted effect.

Trade as a Percent of GNP: Trade is included as a proxy for economic openness. We calculate it as the sum of the share of GNP represented by imports and the share represented by exports. The logic is that economies that trade more will be open, competitive economies. Trade should have two effects. First, more competitive markets should place downward pressure on interest rate spreads. Second, open economies are likely to allow their consumers to seek opportunities outside the domestic market. This should place further competitive pressure on the home market. Our expectation is that trade will correlate negatively with interest rate spreads. The more a country trades, the lower its interest rate spread.

Table 4: Expected signs on the coefficients of the independent variables

Independent variable	Expected sign
Effective threshold	Negative
Gross National Product	Negative
Gross Domestic Savings	Negative
Gross National Product per capita	Negative
Inflation	No prediction
Government Budget Deficit as a Percent of GNP	No prediction
Gross National Product Annual Growth Rate	Positive
Government Debt as a Percent of GNP	Positive
Money Supply (M2)	Negative
Trade as a Percent of GNP	Negative

The final control variable included is a one-year lag of the dependent variable. The lagged variable correlates with the dependent variable at 0.832 and the coefficient on the lagged variable in the regression analysis runs from 0.57 to 0.78. Although we produce a table in which all models contain the lagged dependent variable, electoral threshold remains statistically significant at 0.01 when the lag is dropped as well. There are additional control variables we would like to have included but for which we do not yet have suitable proxies. We need, for example, more complete money supply figures and government debt figures for several small European countries. Also, some measure of loan risk would be useful. Alternatively, if some countries have a variety of alternatives to bank lending available to borrowers, such as active bond and equity markets, banks may have to turn to less stable borrowers to secure business

which would increase the expected interest rate spread. In other words, if banks in certain countries have higher loan-risk ratios, they should also have higher interest rate spreads. At present we are unable to control for this factor but we believe that our figures are adequate for drawing useful inferences. In the next section we turn to the results.

4.4. Results

To see how our argument about the effects of electoral systems fares, we ran a regression of effective threshold on interest rate spreads in 23 countries from 1980 to 1998.¹⁰ Although this captures electoral effects on banking competition rather than on prudential rules per se, levels of competition show a positive correlation with levels of prudential regulation, for reasons we laid out in Section 2.1. We understand that this is a crude and indirect proxy for prudential regulation, because high levels of competition can exist, at least for a time, without prudential safeguards. But we suggest that such circumstances are unlikely to survive for long. Financial institutions sometimes fail, and politicians are typically loathe to allow such things on their watch.

We predict that levels of competition, as reflected in relative prices across countries, have a negative correlation with the effective threshold that a country's electoral system generates. Table 4 offers six takes on our theory's underlying model. Effective threshold is significant in all six. The coefficient is negative as expected. This suggests that electoral institutions have a relatively large effect on interest rate spreads. A qualitative interpretation of the least of the

¹⁰ We understand that being able to run a fixed-effects model would be ideal. Fixed-effect models use country specific dummy variables to soak up the variance explained by other country-specific factors. This method has become standard when working with cross-country data. Unfortunately, such a model is not possible in this instance. Electoral rules vary little within countries, as electoral rules are relatively constant. Also, since our main explanatory variable, effective threshold, is constant in all but five countries, it would be highly correlated with the country

coefficients on effective threshold suggests that a change from a pure SMD system with effective threshold of 35, to a pure PR system with an effective threshold of say 1 (for a 100 member legislature) corresponds to a change of about 0.91 interest rate points (in Model 4). This difference, of nearly one-percent, represents a significant cost difference of borrowing between countries with different electoral institutions.

The models are estimated as time-series, cross-sectional data using panel corrected standard errors. The disturbance of covariance matrix is calculated using pairwise computation since not all panels are the same size. We also employ random-effects models rather than a fixed-effects model since our primary independent variable, effective threshold, does not vary in most of the countries we examine. In the few countries that have altered their electoral systems, the changes have been recent (New Zealand, Italy, and Japan), short lived (France), or minimal (Norway). Without variation within a panel, there are naturally no fixed effects to test for within panels. Still, we think it is important to employ a time-series model to test some of the alternative explanations with control variables that do vary within and across panels.

The range of coefficients for effective threshold, excluding models five and six, which suffer from small numbers of observations, extend from -0.0145 to -0.061. Interestingly, the lowest value for the coefficient on effective threshold occurs in the simple bivariate regression. Qualitative interpretation of these coefficients across models reveals a range from 0.51 to 2.14 percent when we compare a majoritarian system against a pure PR system. In other words, the prediction is that a PR system will have an interest rate spread of up to two percentage points higher than under a SMD system in each model.

dummy variables of a fixed-effects model. As a result, we use a PCSE model with country-level random effects, which is explained in the text.

Table 5: Random effects OLS estimates of the effects of electoral institutions on interest rate spreads for industrial democracies, 1978-1998.

PCSE OLS Regression Estimates (with Z-statistics in parentheses)

	1	2	3	4	5	6
Effective Threshold	-0.0145*** (-3.27)	-0.0196*** (-3.70)	-0.024*** (-3.50)	-.026*** (-3.79)	-0.036*** (-4.04)	-0.06*** (-3.37)
Lagged Dependent Variable	0.778*** (17.49)	0.75*** (15.79)	0.715*** (14.13)	0.71*** (14.22)	0.68* (10.60)	0.567*** (6.07)
Gross National Product		-3.5e-14** (-2.32)	-2.2e-14 (-0.93)	-8.3e-14** (-2.26)	-1.1e-13** (-2.24)	-1.8e-13** (-2.29)
Gross Domestic Savings		-0.038*** (-2.84)	-0.027 (-1.44)	-0.0297 (-1.56)	-0.049* (-1.66)	-0.082** (-2.23)
Gross National Product per capita			-7.95e-06 (-0.64)	2.17e-07 (0.02)	1.49e-5 (0.75)	-3.10e-06 (-0.10)
Inflation			0.0045 (0.24)	-0.0035 (0.19)	0.007 (0.35)	-0.011 (-0.46)
Government Budget Deficit as % of GNP			-0.0094 (-0.52)	-0.0087 (-0.48)	-0.0057 (-0.20)	0.022 (0.45)
GNP Annual Growth Rate		-0.031 (1.02)	0.036 (1.11)	0.052 (1.49)	0.049 (1.25)	0.056 (0.84)
Government Debt as % of GNP					0.004 (1.25)	-0.0012 (-0.20)
Money Supply						-0.11 (-1.21)
Trade as a % of GNP				-0.005*** (-2.84)	-0.0085*** (-3.13)	-0.019 (-1.57)
Constant	1.15*** (4.74)	2.165*** (4.52)	2.24*** (3.47)	2.52*** (3.89)	2.93** (3.73)	6.84*** (4.05)
N	368	338	321	321	217	110
Adj. R ²	0.699	0.699	0.689	0.693	0.702	0.735

(* P>|z| at .1; ** P>|z| at .05; ***P>|z| at .01)

This regression offers substantial evidence of the impact of electoral competition on interest rate spreads. Interest rate spreads represent cross-national price variation in this test. We expected that countries with centrifugal electoral systems to have higher prices because producers should be able to find favorable representation of their interests under such rules. The analysis therefore offers a useful test of our argument.

None of the control variables is highly or consistently significant though some are close. Gross National Product is moving towards significance in the better specified models and warrant a closer look when we have better data. Gross domestic savings is consistently negative and occasionally significant. Money supply, in Model 6, may prove useful if the data were to become available. And trade as a percent of GNP is always negative and occasionally reaches statistical significance at 0.05.

In Model 5 we use the variable government debt as a share of GNP. Though this is certainly useful as a control variable, data limitations reduce the number of observations when using government debt. Consequently, we leave this variable out of most models. Still, this variable offers a useful control on the demand for savings.

The coefficient for our causal variable is significant and in the expected direction. By contrast, none of the control variables are always significant. Four control variables have negative effects in the expected direction, Gross National Product, Gross Domestic Savings, Money Supply (which only occurs in one model for lack of data), and Trade as a Percent of GNP. We also expected per capita GNP to be negative but its results were mixed and were never significant.

There were two variables that we expected to have positive signs, GNP annual growth and government debt. GNP annual growth is negative only once and positive in the four larger models. Government debt gives mixed results and arises only twice due to data limitations. Two variables for which we offered no prediction, Inflation and Government Budget Deficit as a Percent of GNP, came back with mixed results depending upon the specification of each model and these coefficients were never statistically significant.

Table 6: Expected signs on the coefficients of the independent variables

Independent variable	Expected sign	Actual Sign
Effective threshold	Negative	Negative^o
Gross National Product	Negative	Negative
Gross Domestic Savings	Negative	Negative
GNP per capita	Negative	Mixed
Inflation	No prediction	Mixed
Government Budget Deficit as a Percent of GNP	No prediction	Mixed
Gross National Product Annual Growth Rate	Positive	Mixed
Government Debt as a Percent of GNP	Positive	Mixed
Money Supply (M2)	Negative	Negative
Trade as a Percent of GNP	Negative	Negative

^o Bold indicates independent variables that are statistically significant at 0.01 in multiple models.

*Mixed denotes independent variables that took on different signs under different specifications of the model.

We clearly have a problem of insufficient data. Two control variables, Money Supply and Government Debt as a Percent of GNP, are missing many observations. When we include Money Supply, the number of observations drops by more than half. When we include Government Debt as a Percent of GNP, the number of observations drops by nearly one-third. Future work is needed to fill in the gaps left by these missing observations.

Of course, there are control variables that can be imagined as important to the specification of any model predicting interest rate spreads that are simply unknowable, at least at present. For example, if the average loan risk varies across countries, then interest rate spreads should also vary positively with increased risk. In fact, the most recent efforts by the Bank for International Settlements' Committee on Banking Supervision are directed toward requiring loan risk assessments for grading capital reserves. A measure of differences between countries in relative loan risk would clearly explain some portion of the variation in interest rate spreads.

5. Testing the Argument: The Case Studies

In this section, we check the causal logic implied by our summary statistics by looking carefully at several cases of important financial powers that vary on the electoral rules variable. Because our expectation is that different electoral rules produce different political incentives with respect to banking policy and its resulting market structure, we examine whether that is indeed the case in the UK, the U.S., Germany, and Japan.

Numerous regulatory choices collectively affect the competitiveness of financial sectors. Regulators can reduce competition by limiting entry, by fixing prices, and by controlling product variation. Entry, for example, can be limited by requiring government approval through licensing. The potential for market competition is greater when notifying the government is all that is required to enter a market.

	Japan (before 1996)	Japan (after 1996)	Germany	United Kingdom	United States
Entry	<i>By license</i>	<i>By application</i>	<i>By license</i>	<i>By application</i>	<i>By application</i>
Prices	<i>Regulated</i>	<i>Not regulated</i>	<i>Regulated</i>	<i>Not regulated</i>	<i>Not regulated</i>
Product Variety	<i>Regulated</i>	<i>By application</i>	<i>Regulated</i>	<i>Not regulated</i>	<i>Not regulated</i>
Prudential Measures	<i>Moderate, but weakly enforced</i>	<i>Moderate, enforced</i>	<i>Moderate with flexible</i>	<i>Strong</i>	<i>Strong</i>

			<i>enforcement</i>		
--	--	--	--------------------	--	--

We expect that prudential bank regulatory measures will correspond inversely with the orientation of a regulatory regime toward promoting competition. That is, strong and comprehensive prudential regulation will commonly occur in systems with regulatory systems that promote market competition. Conversely, where regulation limits competition, governments can afford to limit the scope of prudential regulation.

With these case studies we are illustrating how the aggregation of policy decisions will push policy either toward favoring producers or consumers depending on electoral incentives. We expect politicians faced with centrifugal incentives as in Germany and Japan, to protect the interests of producers (or limit the inroads made by consumers). By contrast, centripetal rules give politicians an incentive to extend the benefits of competitive markets to consumers. This can clearly be seen in each of the four cases. In the UK and the U.S., financial regulatory changes typically expand competition among the producers of financial services, which, in turn, benefits consumers. But in Germany and (until 1996) in Japan, the evolving financial regulatory systems maintained stable relationships between financial firms and producers of other goods and services. When global capital markets have upset domestic relationships among producers, PR governments are more likely than majoritarian governments to try to restore the balance. In these case studies we demonstrate that these broad characterizations hold.

5.1. The Politics of Banking Regulation in the UK

The UK's single member district system, our argument predicts, will generate banking regulation that favors consumers over producers. How does this comport with reality? Regulatory entry barriers are low, and the market is competitive, as we would expect. But it is

also well known that the UK has a long tradition of self-governance for its financial institutions, which in some ways more closely resembles the pattern of supportive regulation typical of proportional representation countries.

For our analysis, it is crucial to note that the UK's Financial Services Authority gets its reputation for friendliness to banks for its careful assignment of capital requirements, bank by bank, on the basis of the riskiness of each banks' loan and transaction portfolio. Banks with asset portfolios that are judged less risky get stuck with a lower capital charge than banks whose portfolios hold riskier assets. The British financial authorities are known for careful scrutiny, and for rewarding strong bank management with less stringent capital requirements, but not for subsidizing bank risk through regulatory entry barriers or with guarantees against bank failure.

It is also important to note that, since 1979, when the barrier was removed between foreign exchange transaction and domestic transactions, the government has instituted a stronger deposit insurance scheme to protect domestic accounts. Prior to 1979, when foreign currency transactions were walled off from domestic markets, and the government was able to accord different treatment to domestic and foreign, non-voting, investors. The government seemed to be saying, "We welcome foreign investors and borrowers over here for their business, but we can let them fend for themselves because they're big enough to take care of themselves, they generate business for our banks, and in any case they can't vote us out of office." Once the savings deposits of UK citizens became at stake, with obvious political implications in the event of bank system failure, the government acted quickly to under gird bank monitoring with deposit insurance, but not with restrictions on competition. This case shows that, as we predict, bankers

were not allowed to pass along costs of banking system stability onto the consumers of banking services.

5.2. The Politics of Banking Regulation in the U.S.

The U.S. is also a single member district system, but its financial regulation and markets obviously differ in many important respects from those of the UK. Clearly, all else is not equal when it comes to financial regulation. With this case, we show how idiosyncrasies of the U.S. institutional environment complicate, but do not obliterate, the effects of centripetal political competition.

Compared to the streamlined regulatory oversight in the UK, the U.S. system is characterized by extreme fragmentation of market niches and of regulatory oversight. The Office of the Controller of the Currency (OCC) within the Treasury Department charters and oversees national banks. The Federal Reserve System oversees all bank holding companies and shares responsibility with the states for state banks that are members of the Federal Reserve. The states and the Federal Deposit Insurance Corporation share responsibility for the vast number of state banks that are not members of the Federal Reserve System. And that is just for banks. The Securities Exchange Commission continues to regulate the issuance and trading of stocks and bonds even though the regulatory wall between banks and securities firms is coming down.

On the positive side, financial institutions without an overarching enforcer are unable to maintain cartel like behavior, at least for very long. Over time, most profit-padding features of U.S. banking regulation have fallen to the competition that emerges when no single regulator can maintain the peace among different sorts of financial institutions. This state of affairs would be extremely inconvenient for political parties that depended on the loyalty of organized groups

including banks for electoral support. But in a centripetal system such as the U.S., this allows politicians to serve the interests of small consumers of financial services, who are also, typically, unorganized voters. Banking interests are still served, but not at such great expense as to draw the ire of consumers.

To be sure, there have been some egregious examples of entry barriers and profit-impeding regulation in the U.S., including unit banking (lifted in the 1980s) and Glass-Steagall (lifted in the late 1990s). These policies might suggest that electoral rules do not have the predicted effect in the U.S. In one particularly infamous case, when S&Ls enjoyed a bit of profit padding regulation—interest rate ceilings thanks to Regulation Q—money market funds lured away a large portion of their depositor base. Notice what happened. The S&Ls wanted money market funds to be barred somehow from doing this, but the respective regulatory bodies and their legislative overseers did not help the two industries collude. The result was continued competition between savings deposits and money market funds at a break neck pace. The S&L fiasco ended up costing taxpayers a bundle of money when many of them failed, but that industry was eventually cleaned up and competition continues, along with capital rules, regulatory supervision, and deposit insurance (in other words, prudential regulation) to characterize American banking.

Differences with the UK undoubtedly have something to do with U.S. institutional differences such as presidentialism, open primary elections for party nominations, and federalism, all of which weaken the ability and incentives of legislative party leaders to control backbenchers. One result of all the pulling and hauling among various powerful players in U.S. politics is regulatory fragmentation. For all of its messiness, however, the U.S. system of

banking regulation serves well enough the electoral interests of politicians who compete for the mass of voters in the middle. Though somewhat different from that of the UK, as we saw, the U.S. system of banking regulation is typical of centripetal systems in this respect: markets are competitive and prudential banking regulations imposes many of the costs of bank system stability on banks themselves.

5.3. Banking Politics in Germany

In contrast to that of the UK and U.S., we expect German financial regulation, because of the country's PR electoral rules, to favor producers over small consumers of financial services. We find, in fact, that the way it shields depositors from bank failure is to protect banks from "excessive" competition. A 1967 law sets limits on interest rates for deposits, and establishes barriers to entry for new financial institutions or new branches of old ones (Oberbeck and Baethge, 1989). The German banking authorities also require banks to keep loans within a reasonable multiple of capital (otherwise know as capital adequacy requirements, which are a form of prudential regulation). But the German accounting practices are comparatively lenient, so that 8% capital in Germany would be discounted by a few percentage points if measured by U.S. or UK standards.¹¹

It follows from our argument about the effects of electoral rules that PR rules give institutionalized voice, not only to banks, but to other organized groups such as industry and labor as well. A high capital gains tax that made the selling of shares prohibitively expensive gave banks an incentive to cultivate long term, stable relations with their corporate customers.

¹¹ Interviews with Timothy Clark and George Herbst, The Federal Reserve Bank of New York.

This financial stability, in turn, gave corporations the ability to hold employees through thick and thin.

In 1982 when the CDU-CSU government attempted to roll back some of the protections for labor, it received an electoral drubbing in the next laender elections and backed off. Given the substantial influence that labor has in the political system, it is not surprising that banking regulation in Germany reflects, at least partially, labor's interest in employment stability. Ordinary depositors, if they can be separated from their persona as workers, are the losers in this system.¹² Consumers benefit from the stability and safety of their banks, but at great cost given the lack of competition for their deposits.

5.4. The Politics of Banking in Japan

Japan represents a dynamic case, because Japanese electoral rules moved from centrifugal to centripetal in 1994. The effective threshold of exclusion, the summary measure the vote share necessary for a candidates to secure election under a given electoral rule, more than doubled for candidates in Japan's new SMDs, from 16.4 to 35. Each candidate needs a much larger vote share than in the past to win an election. Altered electoral incentives mean that politicians can no longer afford to alienate large segments of their constituency by championing particularistic interests. With the increased cost of providing policy favors, politicians have an incentive to make such favors as cost effective (efficient) as possible. As our argument would predict, banking regulation has moved, in the years following the electoral change, from the profit-

¹² Another feature of the German banking system that we do not have the space to delve into here is its strong federal character (Herrigel 1998; Deeg 1999). Commercial banks are unhappy about the "profit padding" of state banks that gives them an unfair advantage. This conflict is likely to sharpen if large firms increasingly go outside Germany for cheaper and more flexible financing, leaving big commercial banks to go after (less mobile) small and medium sized borrowers.

padding corner of the matrix to something far closer to the prudential quadrant. We argue here that these parallel shifts in electoral incentives and policy outcomes are no coincidence.

In much of postwar Japan, large and small banks benefited from fond government attention and cartel-like regulation that limited price competition for deposits. At least until the Euromarkets began siphoning off corporate customers in the mid-1970s, stiff entry barriers and walls between different types of financial institutions muted competition for borrowers. This was the famous “convoy” system of banking regulation, in which the Ministry of Finance kept innovation and competition to a slow enough pace that even the smallest of financial institutions could survive. The MOF prided itself on not letting a single bank fail.

As a result, banking was the most profitable sector in Japanese industry. It was also the most influential. By rationing funds to favored customers and holding their stocks, banks shaped corporate growth strategies and restructurings (Calder 1993). Also important, restrictions on competition such as constraints on expansion of branch networks, fixed interest rates, controlled product innovation, restricted entry and numerous other petty limitation on potential sources of competition between banks all served to inflate bank earnings above what would occur in a competitive market.

Underlying Japan’s bank-nurturing regulatory policy was a political system that gave politicians strong incentives to curry the favor of producer groups.¹³ Partly to blame were the multimember district, single-nontransferable vote (MMD, SNTV) electoral rules for the more powerful Lower House, in which two to six representatives (average district size was four) were elected from each district. Any party seeking to gain or maintain a legislative majority had to

field multiple candidates in most districts. The resulting intra-party competition for votes and campaign funding led majority party politicians to cultivate personal support networks (*koenkai*) at the expense of a coherent party platform that tried to make sense of issues. Instead of appealing to voters on the basis of ideas about the public good, politicians busied themselves selling regulation to industries, including the banking one, and using that money to curry favor with voters back home. Banking regulation, bought and paid for by the banks, ensured smooth transmission of savings into industry as long as banking remained profitable.

Competition from the Euromarket, beginning in the mid-1970s, began to erode banking profits because it made MOF-supported cartels at home untenable. Such was the political power of Japan's corporate world that the government did not even try to stop this trend. Instead, Japanese banks followed their erstwhile customers abroad, and soon became some of the fiercest competitors in the market. Japanese banks were, essentially, replacing lucrative domestic business with razor-thin profit margins abroad. Japanese banks remained afloat courtesy of the still-protected retail sector back home and the MOF's implicit guarantee that no Japanese bank would fail.

Finding itself in the dangerous Quadrant IV, of low prudential rules and high competition, the MOF attempted to strengthen the legal basis of its regulatory oversight. But in every instance, MOF was rebuffed by the politicians who have the power to pass or to scrap the laws that the bureaucrats draft. In exchange for hefty campaign contributions from banks, the ruling Liberal Democratic Party ensured that the MOF's role in the banking industry was more of a mother hen than that of a stern disciplinarian.

¹³ We are taking sides here, of course, in an ongoing debate by claiming that political factors shaped policy choices in Japan to a significant degree.

This institutional roadblock to financial reform was not broken until the electoral reform in 1994 changed politicians' incentives. The bursting of Japan's asset bubble in 1990 and 1991 pulled the floor out from under the Japanese stock market, forcing many financial institutions to the brink of insolvency. Whether or not politicians realized it (only some remarked on it explicitly), the Japanese political system was no longer compatible with Japan's growing exposure to the world economy. What politicians did recognize was that their electoral chances under the old rules were becoming harder to gauge, prompting them to change the rules that got them elected in the first place.

Under the new electoral rules, a combined system of 300 single member districts and 200 seats from PR lists (now 180) forced politicians to go after average voters instead of the narrow electoral niches that sufficed in years past. The Japanese system adds the seats from the SMD races to the seats won on the PR lists for a total count of legislative seats that a party wins. This differs from the German system, where the PR lists determine the numbers of seats that parties get in the legislature. Japan's system is therefore considerably more centripetal than Germany's. This is particularly true for large parties that hope to be competitive in SMDs.

The interests of voters as consumers had been an afterthought in the convoy rules. They had, of course, paid for financial stability with inflated prices for financial services. "Big Bang" legislation, announced in 1996 and enacted during 1997 and 1998, by contrast, forced banks and securities increasingly to pay for financial stability themselves, by the prudential management of

risk that new rules required. To back up the promise, bank regulatory authority was transferred from the MOF to a new watchdog agency, the Financial Services Authority.¹⁴

Politicians are masters of compromise, and even under the new electoral rules they are searching for ways to protect a favored interest group, small and medium sized enterprises. These constitute the vast majority of businesses in Japan, in terms of numbers and of employment. Over the objections of financial bureaucrats and some politicians, the government has decided for the time being to allow small banks to operate at a lower capital standard of 4%. Banks that only satisfy the 4% standard are only allowed to operate in the domestic Japanese market.

This constitutes a remaining chunk of profit padding for the sake of small businesses that do not have the economic scale or financial promise to raise funds in international wholesale markets. In exchange for this lower capital requirement, the “domestic banks” are required to show that a substantial portion of their loans is to local business enterprises (*Kinyu Janaru*, September 1999, pp. 101-115; December 1999, pp. 113-117). It remains to be seen, however, what will happen to inefficient banks when they are faced with growing competition from the efficient banking sector. Voters are now empowered, as they were not under the old electoral rules, to punish more easily politicians who use public money to rescue unworthy causes.¹⁵

An indication that inefficient banks are operating on borrowed time came in February 2000 when the then head of the Financial Reconstruction Commission was sacked for suggesting

¹⁴ Hiwatari. The agency was originally named the Financial Supervisory Agency, but renamed the Financial Services Agency in July 2000. The similarity to the UK’s Financial Services Authority is no mistake. The officials in Japan’s FSA wanted to make it clear that their mandate is not to prop up decaying banks but to ensure the safety and quality of financial services.

¹⁵ See, for example, the LDP’s hasty retreat from bailing out Sogo Department Store. *Asahi Shimbun*, various issues in July 2000.

that he, or other politicians, could intervene on behalf of weak banks in the event of tough audits from bank supervisors.¹⁶ Weeks later, a group of politicians were rebuffed in their attempt to exempt small banks from mandatory deposit insurance. Had they succeeded, financial authorities would have been obliged to ensure through other means, such as profit padding and regulatory forbearance, that small banks did not fail. As it happened, politicians read the stern warnings in the opinion polls and voted for a year's delay in deposit insurance instead.¹⁷ As of this writing, the deposit insurance limit of ¥10 million per institution is expected to take effect on time on April 1, 2002. Ordinary depositors have already responded to the new regulation by moving funds to banks that are felt to be safe and by distributing their savings among multiple deposit institutions to disperse risk and stay under the deposit insurance limit.

6. Conclusions

This paper has stressed the policy consequences of electoral rules, and specifically, the extent to which those rules do or do not force politicians to go after the median voter as the classic Downsian model predicts. Banking regulation, we ventured, is a particularly apt testing ground for such a proposition, because cross border financial flows have put to question the importance of domestic determinants in this sector as in no other. Our evidence, based both on broad statistical indicators from 23 countries, as well as from a closer look at four cases, suggests that this electoral variable seems to carry some analytical weight and bears further scrutiny.

¹⁶ The Financial Reconstruction Commission was a temporary body created to oversee Japan's banking system crisis and assist with the disposal of nonperforming loans.

¹⁷ Jinno Naohiko, "Sefuti netto naki kisei kanwa no kiketsu," *Keizai Seminaa*, December 1999: 30-33; Hayashi Hiromi, "Kojin no kinyu shisan sentaku kodo de nonkakuteki henka," *Kinyu Zaisei Jijo*, November 29, 1999: 12,15; *Asahi Shimbun* and *Nihon Keizai Shimbun*, various issues, December 1999-March 2000. Two years later, the Diet voted down another attempt to extend the delay through March 2003.

We invite scholars of comparative political economy to consider the policy consequences of centripetal and centrifugal electoral systems more generally, for these may provide some of the microfoundations for “varieties of capitalism.”¹⁸ The banking case notwithstanding, it is not true that centripetal systems are better at providing public goods in general. Environmental protection, for example, seems to be at least as strong, if not stronger, in European PR systems as in the U.S. and UK. What difference does it make that centripetal systems privilege the kinds of issues that most people care about at least somewhat, such as consumer interests, whereas centrifugal systems produce log rolls among smaller groups with more intense preferences? More work is needed to understand a fuller range of policy effects of broad pre-election coalitions (big, heterogeneous parties) which centripetal systems produce, compared to those of post-election coalitions (multi-party governments) which emerge from centrifugal systems.

Implicit in this paper is a second issue, one that we dealt with only tangentially. What is the future of national banking regulation if global economic integration is forcing politicians to choose increasingly between prudential rules in Quadrant II, or dangerous exposure to financial instability in Quadrant IV? Governments still have a wide range of levers on social and economic policy, globalization notwithstanding. However, the encroachment of market competition does put many of these levers to a test, as we saw most dramatically in the Japanese case. Banking was never, in any case, a particularly effective way for government to manipulate the economy, if Japan and Germany are any indication. Now that profit padding is harder than ever to justify, bankers will have to work hard to earn a living, just like everyone else.

Immobile sectors, meanwhile, including retail banking and small business financing, will likely remain distinct across countries for some time to come. Differences may diminish in the

¹⁸ See, for example, the book edited by Peter Hall and David Soskice (2001) by that title.

European Union, particularly under monetary union, where banks have “passports” and can operate in any country under home rules. But in Germany, laender governments still subsidize laender banks for the benefit of small and medium sized borrowers.¹⁹ In Japan, small banks have for the time being retained some padding in their profits. The time may come when small business borrowers and average consumers will choose more efficient banks on their own accord, forcing industry consolidation that small banks resist. Political choices, not unaided markets, will determine whether or not the government will step in to protect small banks. Customers in Japan may now have the electoral power to make this protection too costly, politically.

¹⁹ A case against the laender bank subsidies, brought by none other than German commercial banks, is pending in the European Court of Justice.

References

- Abe, Motoo. 1999. "BIS kijun no moten o ninshiki seyo [Let's Recognize the Blind Spots of the BIS Rules]." *Ekonomisuto*. March 16, 80-3.
- Angeloni, I. And Dedola, L. 1999. "From the ERM to the Euro: New Evidence on Economic and Policy Convergence among the EU Countries." European Central Bank Working Paper No. 4, May.
- Asahi Shimbun, various issues.
- Austen-Smith, David. 2000. Redistributing Income Under Proportional Representation. *Journal of Political Economy*. 108: 1235-1269.
- Basel Committee on Banking Supervision. 1999. "A New Capital Adequacy Framework." <http://www.bis.org/publ/bcbs50.html>.
- Bhattacharya, Sudipto, and Thakor, Anjan. 1993. "Contemporary Banking Theory." *Journal of Financial Intermediation*. 3:2-50.
- Billett, Matthew, Garfinkel, Jon, and O'Neal, Edward. 1998. "The Cost of Market Versus Regulatory Discipline in Banking." *Journal of Financial Economics*. 48: 333-358.
- Birchfield, Vicki, and Mardu L.Crepaz. 1998. The Impact of Constitutional Structures and Collective and Competitive Veto Points on Income Inequality in Industrialized Democracies. *European Journal of Political Research*. 34: 175-200.
- Bronfman, Corinne, Lehn, Kenneth, and Schwartz, Robert. 1994. "U.S. Securities Markets Regulation: Regulatory Structure." In *International Financial Market Regulation* edited by Benn Steil, 37-74. West Sussex: John Wiley & Sons.
- Calder, Kent. 1993. *Strategic Capitalism*. Princeton: Princeton University Press.
- Cantor, Richard, and Packer, Frank. 1994. "The Credit Rating Industry." *FRBNY Quarterly Review*. Summer-Fall.
- Cerny, Philip. 1994. "Gridlock and Decline: Financial Internationalization, Banking Politics, and the American Political Press." In *Political Economy and the Changing Global Order* edited by Richard Stubbs and Geoffrey Underhill. New York: St. Martin's Press, 425-438.
- Cohen, Benjamin J. "Phoenix Risen: The Resurrection of Global Finance," *World Politics* 48,2: 268-96.
- Coleman, William. 1996. *Financial Services, Globalization, and Domestic Policy Change*. New York: St. Martin's Press.
- Coleman, William and Porter, Tony. 1994. "Regulation International Banking and Securities: Emerging Cooperation among National Authorities." In *Political Economy and the Changing Global Order* edited by Richard Stubbs and Geoffrey Underhill, 190-203.
- Coleman, William, and Underhill, Geoffrey. 1995. "Globalization, Regionalism, and the Regulation of Securities Markets." *Journal of European Public Policy*. 2,3: 488-513.
- Community Legislation in Force, various documents. <http://europa.eu.int/eur-lex/en/lif/dat>.
- Cox, Gary. 1990. "Centripetal and Centrifugal Incentives in Electoral Systems," *American Journal of Political Science* 34:903-35.

- Cox, Gary. 1999. "Electoral Rules and the Calculus of Mobilization," *Legislative Studies Quarterly*, 24,3: 387-419.
- Dale, Richard. 1994. "International Banking Regulation." In *International Financial Market Regulation* edited by Benn Steil. West Sussex: John Wiley & Sons, 167-96.
- Davies, Howard. 1999. "Basel Conference." December.
<http://www.fsa.gov.uk/pubs/speeches/sp37/html>.
- Davies, Howard. 2000. "Global Markets, Global Regulation." Speech presented at IOSCO Annual Conference, May 17. <http://www.fsa.gov.uk/pubs/speeches/sp45.html>.
- De Bandt, Olivier, and Davis, E. Philip. 1999. "A Cross-Country Comparison of Market Structures in European Banking." *European Central Bank Working Paper No. 7*. September.
- De Bandt, Olivier, and Mongelli, Francesco. 2000. "Convergence of Fiscal Policies in the Euro Area." *European Central Bank Working Paper No. 20*. May.
- Deeg, Richard. 1999. *Finance Capitalism Unveiled: Banks and the German Political Economy*. Ann Arbor: The University of Michigan Press.
- Economist. 1999. "Capital Ideas." April 17. <http://www.economist.com/archive/view.cgi>.
- Dermine, Jean. 1994. "EC Banking Regulation." In *International Financial Market Regulation*, edited by Benn Steil. West Sussex: John Wiley & Sons.
- Deutsche Bundesbank Monthly Report. 1998. "Opinion of the Central Bank Council Concerning Convergence in the European Union in View of Stage Three of Economic Monetary Union." April.
- Financial Supervisory Agency of Japan. 2000. "The Status of Risk Management Loans Held by All Banks in Japan." January 27. http://www.fsa.go.jp/news/newse/ne_030a.html.
- Fратиани, Michele. 1995. "Bank Deposit Insurance in the European Union." In *Politics and Institutions in an Integrated Europe*, edited by B. Eichengreen, J. Frieden, and J. von Hagen, 144-176.
- Fратиани, Michelle and Pattison, John. 2000. "Reconciling Global Financial Markets and National Regulation: The Role of the Bank for International Settlements," paper prepared for the Political Economy of International Monetary and Financial Institutions, Center for German and European Studies, UC Berkeley.
- Genschel, Philippe, and Plumper, Thomas. 1997. "Regulatory Competition and International Cooperation," *Journal of European Public Policy* 4/4: 626-42.
- Gerschenkron, Alexander. 1962. *Economic Backwardness in Historical Perspective*. Cambridge: Harvard University Press.
- Hall, Peter, and Soskice, David, eds. 2001. *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. New York: Oxford University Press.
- Hayashi, Hiromi. 1999. "Kojin no kinyu shisan sentaku kodo [Choices in personal financial asset management]" *Kinyu zaisei jijo*, 11/29: 12-15.
- Helleiner, Eric. 1996. *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s*. Ithaca: Cornell University Press.

- Hellmann, Thomas, Murdock, Kevin, and Stiglitz, Joseph. 2000. "Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?" *The American Economic Review*. 90,1:147-64.
- Herrigel, Gary. 1998. *Industrial Constructions: The Sources of German Industrial Power*. New York: Cambridge University Press.
- Hideshima, Hirotaka. 1999. "Bazeru goi minaoshi ni kansuru shichu kyogi pepa ni tsuite [Regarding the Basel Consultative Paper]" *Kinyu*. July, 4-14.
- Higashitani, Satoshi. 1999. *BIS kisei no uso [The Lie of BIS Rules]*. Tokyo: Nikkan kogyo shimbunsha.
- Hiwatari, Nobuhiro. 2000. "The Reorganization of Japan's Financial Bureaucracy: Politics of Bureaucratic Structure and Blam Avoidance," in Patrick and Hoshi, eds., *Crisis and Change in the Japanese Financial System* (Boston: Kluwer Publishers).
- Hoshi, Toshio, and Kashyap, Anil. 1998. "The Japanese Banking Crisis: Where Did it Come From and How Will It End?" Ms.
- Hosli, Madeleine. 1996. "Coalitions and Power: Effects of Qualified Majority Voting in the Council of the European Union." *Journal of Common Market Studies*. 34,2: 256-73.
- House of Councillors, Government of Japan. 1999. Finance Committee minutes. August 6.
- House of Representatives, Government of Japan. 1999. Finance Committee minutes. July 6.
- Jinno Naohiko, "Sefuti netto naki kisei kanwa no kiketsu," *Keizai Seminaa*, December 1999: 30-33; Hayashi Hiromi, "Kojin no kinyu shisan sentaku kodo ne nonkakuteki henka," *Kinyu Zaisei Jijo*, November 29, 1999.
- Kane, Edward. 1987. "Competitive Financial Regulation: An International Perspective," in *Threats to International Financial Stability*. Edited by Portes and Swoboda. New York: Cambridge University Press.
- Kapstein, Ethan. 1989. "Resolving the Regulator's Dilemma: International Coordination of Banking Regulations." *International Organization* 43,2: 323-47.
- Kapstein, Ethan. 1992. "Between Power and Purpose: Central Banks and the Politics of Regulatory Convergence." *International Organization* 46,1: 265-87.
- Kapstein, Ethan. 1996. *Governing the Global Economy: International Finance and the State*. Cambridge: Harvard University Press.
- Kapstein, Ethan. 2000. "Winners and Losers in the Global Economy." *International Organization*. 54,2: 359-84.
- Kinyu Janaru, various issues
- Kinyu Zaisei Jijo. 1999. "Tokushu: BIS kisei minaoshi no ronten [Special Issue: BIS Revisions]." June 21. <http://www.numtech.co.jp/documents/19990621/intex.html>.
- Laffont, Jean-Jacques, and Tirole, Jean. 1991. "The Politics of Government Decision-Making: A Theory of Regulatory Capture," *Quarterly Journal of Economics*: 1089-1127.
- Lijphart, Arend. 1994. *Electoral Systems and Party Systems: A Study of Twenty-Seven Democracies, 1945-1990*. New York: Oxford University Press.
- Loewendahl, Henry. 1999. "Siemens' "Anglo Saxon" Strategy: Is Globalizing Business Enough?" *German Politics*. 8,1: 89-105.

- Luetz, Susanne. 2000a. "From Managed to Market Capitalism? German Finance in Transition." Max Planck Institute fur Gesellschaftsforschung Discussion Paper 00/2, May.
- Luetz, Susanne. 2000b. "Beyond the Basle Accord: Banking Regulation in a System of Multilevel Governance." Paper delivered at the Annual Convention of the International Studies Association, March.
- Luetz, Susanne. 1998. "The Revival of The Nation-State? Stock Exchange Regulation in an Era of Globalized Financial Markets." *Journal of European Public Policy*, 5,1: 153-68.
- McDonough, William. 1998. "Issues for the Basle Accord." Speech presented at the Conference on Credit Risk Modeling and Regulatory Implications. September 22. <http://www.ny.frb.org/pihome/news/speeches/mcd980922.html>.
- McDonough, William. 1999. "The Changing Role of Bank Capital." Speech presented at the Japan Society. January 20. <http://www.ny.frb.org/pihome/news/speeches/mcd990120.html>.
- McGillivray, Fiona. Forthcoming. *Fighting for the Marginals: Political Institutions and Industry Handouts*. Princeton University Press.
- Merton, Robert. 1977. "An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees." *Journal of Banking and Finance*. 1:3-11.
- Milne, Alistair and Whalley, Elizabeth. 1998. "Bank Capital and Risk Taking." Bank of England, ISSN 1368-5562.
- Moran, Michael. 1991. *The Politics of the Financial Services Revolution: The USA, UK and Japan*. London: Macmillan.
- Moran, Michael. 1992. "Regulatory Change in German Financial Markets." In *The Politics of German Regulation* edited by Kenneth Dyson. Aldershot, Hants: Dartmouth Publishing Company.
- Mori, Toshihiko. 2000. "Kinyu gurobaru standado o Nippon no te de [Let Japan Help Decide the Global Financial Standard]" *Shukan toyo keizai*. February 12, 104-107.
- Meunier, Sophie. "What Single Voice? European Institutions and EU-U.S. Trade Negotiations." *International Organization*. 54,1: 103-35.
- Myerson, Roger. 1993. "Effectiveness of Electoral Systems for Reducing Government Corruption: A Game-Theoretic Analysis," *Games and Economic Behavior*, 5: 118-132.
- Nihon Keizai Shimbun, various issues
- Oatley, Thomas. Forthcoming. "Do We Need International Financial Regulation?" *Regulation*.
- Oatley, Thomas, and Nabors, Robert. 1998. "Market Failure, Wealth Transfers, and the Basle Accord," *International Organization*. 52,1: 35-54.
- Oberbeck, Herbert, and Baethge, Martin. 1989. "Computer and Pinstripes: Financial Institutions," in *Industry and Politics in West Germany*. Edited by Peter Katzenstein. Ithaca: Cornell University Press, 275-303.
- Peltzman, Sam. 1976. "Toward a More General Theory of Regulation." *Journal of Law and Economics*. 19: pp. 211-240.
- Porter 1993.
- Persson, Torsten, and Guido Tabellini. 2000. Political Institutions and Policy Outcomes: What are the Stylized Facts? Working paper.

- Poon, Winnie, Firth, Michael, and Fung, Hung-Gay. 1999. "A Multivariate Analysis of the Determinants of Moody's Bank Financial Strength Ratings." *Journal of Financial Markets, Institutions, and Money*. 9:267-83.
- Porter, Tony. 1993. *States, Markets, and Regimes in Global Finance*. New York: St. Martin's Press.
- Roubini, Nuriel, and Jeffrey D. Sachs. 1989. Political and Economic Determinants of Budget Deficits in the Industrial Democracies. *European Economic Review*, 33: 903-933.
- Schaede, Ulrike. 1995. "Toward a New System of Corporate Governance in the European Union: An Integrative Model of the Anglo-American and Germanic Systems," in *Politics and Institutions in an Integrated Europe*. Edited by Eichengreen, Frieden, and von Hagen. Berlin: Springer, 93-119.
- Schonfield, Andrew. 1965. *Modern Capitalism: The Changing Balance of Public and Private Power*. New York: Oxford University Press.
- Scott-Quinn, Brian. 1994. "EC Securities Markets Regulations." In *International Financial Market Regulation* edited by Benn Steil. West Sussex: John Wiley & Sons, 121-65.
- Shiota, Ushio. 1999. *Kinyu Arijigoku [The Ant Lion of Finance]*. Tokyo: Nihon keizai shimbunsha.
- Sinn, Hans Werner. 1999. *The German State Banks*. Cheltenham, England: Edward Elgar.
- Sobel, Andrew. 1999. *State Institutions, Private Incentives, Global Capital*. Ann Arbor: The University of Michigan Press.
- Steil, Benn. 1994. "International Securities Markets Regulation." In *International Financial Market Regulation* edited by Benn Steil. West Sussex: John Wiley & Sons, 197-232.
- Stigler, George J. 1971. "The Theory of Economic Regulation." *Bell Journal of Economics and Management Science*.
- Sugita (Kaicho). 1999. Press Conference of the Chairman of the Federation of Bankers Associations. November 15. <http://www.zenginkyo.or.jp/news/newskaiken06.html>.
- Verdier, Daniel. 1998. "Capital Market Internationalization, 1870-1914," *International Organization*. 52,1: 1-34.
- Weingast, Barry. 1984. "The Congressional-Bureaucratic System: A Principal Agent Perspective (With Applications to the SEC)," *Public Choice* 44: 147-91.