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Widen the market, narrow the competition : the emergence of supranational governance in EU capital markets

Mügge, D.K.

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CHAPTER 3: BANKS' INSTITUTIONAL POWER AND DOMESTIC FINANCIAL MARKET REFORM IN THE 1980s

Scholars of financial markets often portray the 1980s as the decade when finance went global and markets were deregulated (e.g. Strange 1998, R. Smith and Walter 2003). Financial regulation was already in flux when capital market opening appeared on the EU agenda in the second half of the 1980s.⁵ In a way, the EU seemed to be jumping onto a moving train.

This wave of domestic market opening has important consequences for analysing EU capital market integration. Most obviously, it may be that EU-level developments were epiphenomenal to domestic regulatory reforms. From this perspective, core changes took place at the national level while EU politics were only a side-line to the main story. The pattern of EU negotiations and regulation, however, do not support this view. The European regime that member states agreed in the early 1990s contained many protectionist clauses. In important respects, it was not an extension of national market liberalization, but contained elements pointing in the opposite direction. So how can the two be squared?

When viewed through the lens of competition politics, the tension between national market liberalization and protectionist rules at the European level disappears. Both, I argue, bear the imprint of financial market incumbents' strategic considerations. While the coming chapters support this claim in terms of EU-level politics, this one shows how it rings true for liberalization at the national level. In doing so, it addresses the apparent tension between an explanation of EU politics stressing strategic agency on the one hand and of national changes supposedly driven by global market structures on the other. The chapter's reappraisal of the 'decade of deregulation' shows how the two complement rather than contradict each other.

⁵ In the 1990s, the European Community (EC) was incorporated in the European Union (EU), the label commonly used since then. For the sake of consistency, 'EU' will be used also for time periods when strictly spoken, 'EC' would be the correct label.

The question of whether regulatory reforms are best understood as de-regulation—the simple abolition of rules—or re-regulation—the creation of new rules, possibly to substitute old ones (cf. Cerny 1994, S. Vogel 1996) will be side-stepped. The debate only makes sense when re-regulation is equated with state control over markets and de-regulation with its loss. As the previous chapter argued, such a state-market dichotomy oversimplifies regulatory politics and ignores how public and private actors are often political partners within what Underhill (2003) has called state-market condominiums. It is thus hardly surprising that financial market reforms have included both de-regulation and re-regulation and a mix of market opening and protectionism.

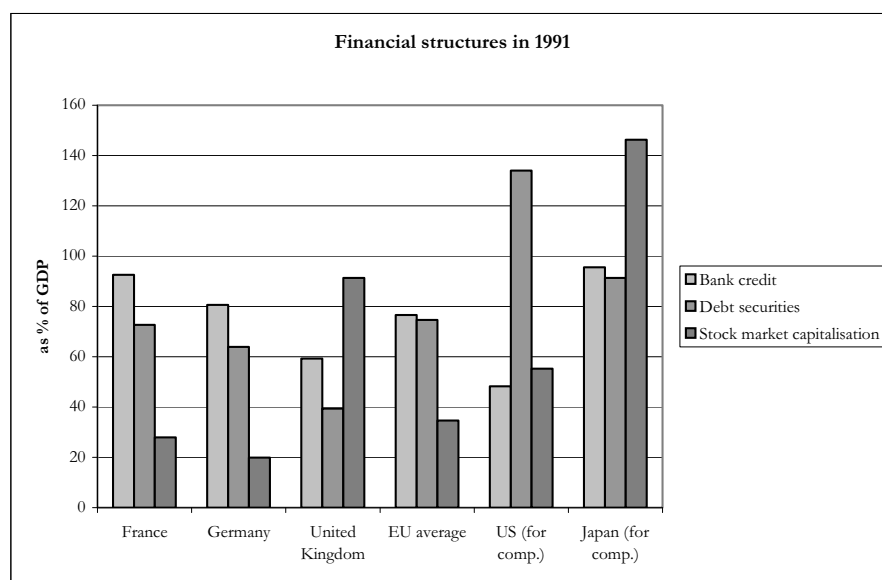
This chapter has a dual importance for the thesis as a whole. First, it shows that EU capital market integration did not unfold against a backdrop of universal financial liberalization driven by global market forces. Rather, the backdrop was one of regulatory reforms heavily influenced by the strategic re-orientation of national financial champions. While domestic reforms reveal national policy-making dynamics, comparing the UK, France and Germany shows the influence of domestic political institutions and different market structures on policy outputs. Second, the analysis exposes the institutional power of financial market incumbents. In this way, the chapter lays bare the domestic side of the international constellation through which national financial industries and ‘their’ governments jointly governed capital markets in Europe at the time.

The chapter begins with a comparative overview of European securities markets at the end of the 1980s. The following three sections then reassess regulatory reforms in Germany, France and the UK. They expose the importance of competition politics and show how national varieties of capitalism left their mark on market structures, political institutions and the interests of both public and private actors.

European capital markets at the end of the 1980s

A comparison of European financial systems and structures at the end of the 1980s shows the

UK in an exceptional position in terms of capital market development (I. Walter and Smith 1989, Gardener and Molyneux 1990). In line with most other European countries, the French and the German financial systems were dominated by bank credit and debt securities, with stock markets playing a secondary role. In the UK, the picture was reversed. In 1985 French stock market capitalisation stood at a mere 13 per cent of GDP, compared to 24 per cent in West Germany and 60 per cent in the UK (Graham 1987b). This pattern was to continue into the early 1990s (graph 1).



Graph 1. Source: European Commission 2003

Elsewhere in the EU, markets for non-government securities were dwarfed by credit markets; only the (small) Benelux countries formed something of an exception. Even Italy, the fourth-largest EU economy at the time, had no significant market for non-government securities (Colvill 1995). For most European countries this meant that their financial institutions and market places had few prospects for ever becoming internationally important. Within European securities markets, the Swiss were the only ones in the same league as Germany, France and the UK—and they remained outside the EU.

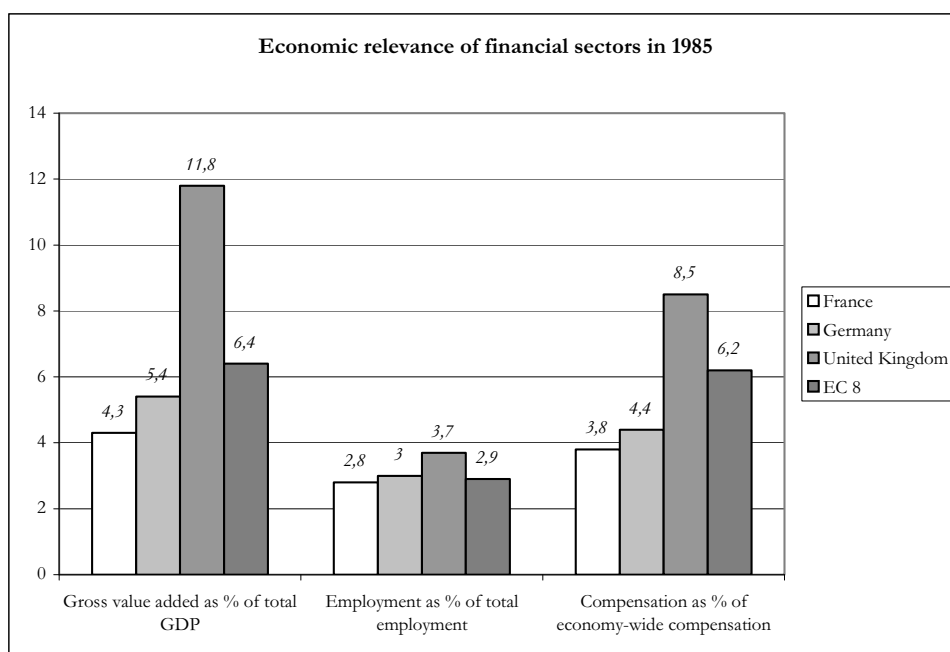
The prominence of capital markets in the UK put the City in a leading position in Europe. In 1992, it boasted 44.1 per cent of the EU's market capitalisation, more than Frankfurt, Paris and Amsterdam combined. Around the same time, 43 per cent of London's equity turnover was in foreign shares; on the continent, the figure was negligible. Over 95 per cent of EU foreign equity turnover went through the City, with German shares accounting for roughly 25 per cent and French ones for half of that (Steil 1993: 3).

The City stuck out in other ways too. To establish the global reputations of firms in the securities business, *Euromoney* polled financial institutions in 1990 and 1991 and asked them to name their favourites. US institutions came out on top with 1,803 votes followed by the UK with 1,213. In contrast, Germany (175) and France (112) fared dismally (Sobel 1994: 132f). The firms' reputations matched that of their home markets. Quantitative studies comparing European financial centres have invariably found London on top with Frankfurt and Paris on the second tier, often alongside Zurich (Bindemann 1999: 24ff).

More interesting are the reasons that respondents in Bindemann's study gave for London's dominance in Europe (Ibid.: 28ff). Commissions—the price for trading—were not among the top ten of the 23 options presented. Investment firms cared little about locally specific operational costs (rank 20 out of 23) and considered fiscal regulation, which affects prices through taxes like the stamp duty, the least important of all. All this challenges the notion of financial centres competing via the cost of their services—central for example in Laurence's work (2001). However, it resonates with Sobel's finding that regulatory reforms show little statistical connection to price developments. Instead, respondents valued the human resources London offered, the diversity and size of its markets, the diversity of its financial products, the presence of international banks, and its transaction volumes as the leading five criteria. Regulation came in sixth place.

The relevance of the financial sector in the national economy differed markedly (graph 2): for employment, the UK was roughly in line with the Community average (3.7 per cent compared

to 2.9 per cent). Financial services' share of national GDP, however, was more than double that of Germany, and almost triple that of France. The sophistication of London's capital markets and the concentration of international business in the City caused compensation levels to be significantly higher in the UK than in Germany or France, even though employment levels were roughly similar. In Britain, finance was—and still is—a major industry in its own right (cf. The Economist 1988).



Graph 2. Source: Gardner and Molyneux 1990: 13

As will be discussed in detail below, equity markets in Germany and France not only differed in size from those in the UK, they also played different roles in the economy (cf. I. Walter and Smith 1989: 68-93). As a first rough-and-ready distinction, British markets functioned to generate returns for investors and as markets for corporate control. On the continent, they were mainly vehicles for industrial policy, direct in the case of France, mediated by the commercial banks in Germany. Accordingly, acquisitions of listed companies opposed by the target were a rarity in continental Europe. Between 1983 and 1988 (included), a mere three

transactions were completed there, with a total value of \$539m (I. Walter and Smith 1989: 60). In the UK, in contrast, 25 such transactions were completed, with a total value of almost \$20bn.

Capital markets in the three countries were entrenched in and supported by detailed regulation. A comparison of withholding taxes is instructive: in 1988, Germany had a 25 per cent tax on dividends but none for bond interest payments. It was reverse in the UK, with dividends untaxed but a 25 per cent tax on gilt interest payments. The German regime thus encouraged firms to retain earnings and reinvest them. It discouraged holding equity for immediate reward (and thereby depressed equity prices) but encouraged bond holding instead. The opposite was true in the UK. And in France? There, the dividing line ran between resident and foreign holders of securities: residents paid no tax for either bond interest or dividends; foreigners had to pay up to 50 per cent for the former and 25 per cent for the latter. The flexible interest withholding tax for bonds is a classic example of French interventionism, trying to fine-tune foreign investment in domestic debt. The dividend tax discouraged foreign equity ownership and was meant to keep business 'in the family'.

The credit markets dominating the French and German financial systems were controlled by national firms—a pattern typical of continental Europe at the time, with the exception of Belgium. In 1988, foreign banks accounted for 13.5 per cent of assets in France and no more than 1.8 per cent of assets in Germany (Gardener and Molyneux 1990: 21). In the UK, foreign-owned banks accounted for more than half of the total. This pattern is all the more remarkable when seen against measures of the formal openness of financial systems, which contradict stereotypical typologies (Grilli 1989). Germany, rather than being in a cluster with other 'coordinated market economies', was ranked by Williamson and Mahar (1998) as the financially most liberal country in the early 1970s out of the 34 they studied, more liberal than the UK or the US. Already before the wave of 'deregulation', the authors detected little overt state intervention. Existing limits to competition rather emerged out of the behaviour of private actors, for example through self-regulation of national financial industries.

The German example shows how the suppression of competition can work in subtle ways. Foreign financial institutions were in principle allowed to have seats on Frankfurt's stock exchange from 1982—almost half a decade earlier than on the London Stock Exchange (LSE) and nearly a decade before the full opening of French markets in this respect (I. Walter 1988: 14). But members of the German exchanges needed banking licences, which automatically excluded most foreign brokers. The tight relationships that corporate clients enjoyed with their Hausbanks meant that in spite of the formal openness of German banking, foreigners made few inroads. As mentioned, the share of foreign banks' assets in 1988 stood at a negligible 1.8 per cent.

The overall picture is one of market fragmentation along national borders and significant differences in financial structures that reflect national varieties of capitalism. These national market places were complemented by the Euromarkets, centred in London, where currencies and securities were traded 'offshore' without technically entering the UK's financial system. These markets grew until the late 1970s but had little impact on domestic markets for financial services. As the coming sections show, this was to change in the 1980s, though the relevance of the Euromarkets for domestic reforms varied.

Regulatory reform in German managed capitalism

For Schmidt (2002), Germany is the archetypal example of 'managed capitalism', which she contrasts with market capitalism (for example the UK) and state capitalism (France). The typology is reminiscent of Zysman's (1983: 91), who distinguished between tripartite-negotiated, company-led and state-led models of economic adjustment.

The managed character of German capitalism was evident in its financial system. German banks were instrumental in the implementation of the Bundesbank's monetary policy as well as the industrial policy of national and regional governments. As has often been noted, such positive coordination (Jayasuriya 2001) of financial market policy with other policy domains generated tight policy communities that bridged the public-private divide (e.g. Coleman 1996). In securities markets, banks were given leeway to set market rules (Lütz 2002).

German industry had traditionally relied on credit rather than equity financing. Firms thus developed tight links with ‘their’ banks—the so-called Hausbanks (Allen and Gale 2000). Stock markets functioned as mechanisms to allocate corporate control—not through the market, but through negotiations between banks, unions and enterprises. Exposure to corporate fortunes through sizable loans were complemented by shareholdings. These equity stakes placed bank representatives on supervisory boards and granted access to inside knowledge and decision-making. In addition, cross-shareholdings tamed potential inter-firm rivalries and thereby limited corporations’ exposure to competition. German markets for corporate equity were thus more of an appendix to the economy than its central battleground. As late as 1990, only 14 per cent of German shares were in foreign hands (Story 1997: 254).

The legal provisions underpinning this system included high capital gains taxes to encourage long-term cross-shareholdings as well as flexibility in accounting for the depreciation of assets to limit companies’ need for quick capital. High corporate taxes further promoted the retention of profits rather than their distribution. Holding equity with an eye for attractive dividends played only a secondary role in Germany. Conversely, the absence of rules on what elsewhere was considered insider trading deterred involvement by foreign firms. Deutschland AG—as the web of German cross-shareholdings became known—thrived on personal connections and informal information channels. This placed system outsiders at a disadvantage and made Germany relatively unattractive in spite of its impressive economic performance and formal openness to foreign banks. Transparency and the concept of insider trading were so unpopular in Frankfurt that Germany stymied EU attempts to introduce binding rules in the early 1980s (McCahery 1997, Interview 020506).

Nevertheless, reform of the system, which had not seen any legal changes since the late 1960s (G. Franke 2000: 71), began in 1984. Deeg (2001: 21) concurs with Vitols, who found that

[i]n Germany reform has been driven for the most part by the large banks, who desire to create a "home base" supportive of global player investment banks on the US model. (Vitols 2003: 18)

With German corporations increasingly relying on their own reserves to finance investment (Story and Walter 1997: 174) and margins in the lending business declining (Overbeck and D'Alessio 1997: 92), banks began searching for new sources of revenue in the early 1980s.

Unable to find enough growth potential in lending and retail banking, they needed to develop fee-based sources of income. Some of this could come from offering services such as consulting to firms, but the big banks quickly determined that their best opportunities lay in financial activities related to capital markets, most importantly underwriting and trading. (Deeg 2001: 23)

Towards this end, capital markets needed to be updated and old restrictions on innovative (and lucrative) financial products lifted. It was in this spirit that the 'Frankfurt coalition'—with large Frankfurt banks at its helm—initiated reforms in the mid-1980s (Lütz 2002: 235).

The first element of these reforms concerned the admission of new financial instruments—for example floating rate notes and zero coupon bonds—and the updating of market structures to create a full-fledged capital market infrastructure. In principle the Bundesbank was eager to boost Frankfurt as a financial centre. But it entertained second thoughts when innovations began interfering with its own tasks (Evans 1992). For example, the Bundesbank at first resisted calls to introduce Certificates of Deposit (CDs). CDs functioned much like time deposits for lenders, but were tradable. The Bundesbank had used banks' reserve requirements against time deposits as its preferred instrument to expand or contract credit. But CDs, it found, did not fall under reserve requirements (Carr 1985c); were they to replace term deposits, the Bundesbank would lose one of its favourite instruments. When it finally did introduce CDs, the Bundesbank introduced reserve requirements (Carr 1985b), though it eventually compensated national banks by lowering the levels required. In another example, it took the Bundesbank until 1990 to approve German banks' underwriting of debt in foreign currencies raised by German corporations (Wall Street Journal 1990). Hitherto this had not been allowed in Frankfurt; the business had been left to London.

These episodes show how the coordinated character of regulatory policy-making slowed reforms in Germany. This was in contrast to France and the UK, where state domination and greater distance between the state and business, respectively, permitted more rapid change. At the same time, disputes in Germany were usually resolved to the satisfaction of business. When the big banks told the finance ministry that specific rules were hampering the development of capital markets and sending business to foreign firms, their concerns were normally heeded. For example, banks in early 1989 were irate over the introduction of withholding taxes for foreign owners of German securities (Simonian 1988a, 1989a). They protested loudly and the tax was soon abolished.

The coordination of policy between large banks and state institutions was even more evident in the selective market opening to foreign banks. In spite of official market openness, many barriers remained, often hidden in arcane rules. In 1986, after consultation with German banks and the Bundesbank, the government invited foreign banks to participate in the Federal Bond Consortium through which the government placed its debt on the market (Carr 1986). The aim was not so much to let foreigners in, but to increase demand for German government securities, thereby driving down financing costs. Almost a third of the new players came from Japan, easing access to that country's huge savings pool. However, with foreign players' share fixed at 20 per cent of the total, there remained clear limits to competition. Foreign firms were not to challenge domestic dominance of the market.

The fixed share for foreign players was only lifted when Germany faced higher financing needs in the wake of reunification. Now the placing power of foreign players became highly important. The Bundesbank introduced a partial auctioning of bonds in 1990, meaning a loosening of fixed quotas (Campbell 1990). The top tier of German banking, however, did not relinquish this lucrative business without compensation. Deutsche Bank's growing international ambitions (Brady 1992) had been frustrated for years by its inability to get a foot into the American primary government bond market. Now that the Bundesbank was about to grant more

freedoms to foreign institutions, the New York Fed reciprocated by granting Deutsche Bank ‘primary dealer’ status (Harverson and Campbell 1990). Liberalization here was not a unilateral affair; it took place on a mutual basis. The main losers—certainly in Germany—were the smaller players such as the cooperatives, which for years had been complaining about the size of their allotments and received nothing in return for falling commissions.

The issue of reciprocity had come up in other liberalizing measures, belying the idea that liberalization was a matter of adapting to ‘global pressures’. In 1985, for example, the Bundesbank had allowed foreign firms to lead-manage foreign issues of DM-denominated bonds in Frankfurt (Davies 1985).⁶ This was to bolster Frankfurt’s standing as a financial centre against the City’s Euromarkets where D-Marks were readily available. Foreign corporations in need of German currency would in all likelihood approach their national banks first. To attract them to Frankfurt, they had to be allowed to lead-manage the issues and take the associated fees. German banks already had such rights in most important countries—except Japan. Thus when the Bundesbank met with foreign banks in Frankfurt, the Japanese firms were informed that they, in effect, would be excluded from the new privileges until Japanese authorities made concessions to German firms (Carr 1985a). Liberalization did not hurt the large German players—they continued to dominate the Frankfurt market. Rather than introducing stiff competition, one senior US banker likened foreign lead managers in Frankfurt to ‘gnats buzzing around German heads’ (Carr 1985d).

The biggest innovation of all was the Deutsche Terminbörse (DTB), a futures and options exchange opened in 1990 (Campbell and Hargreaves 1990). As with many German reforms, it came late—the City’s LIFFE had been opened in 1982, France’s MATIF in 1986 and the Swiss Soffex in 1988. Again, it was to be run and controlled by insiders in the German financial system. German banks were worried that unless Germany established its own exchange,

⁶ A foreign issue in this case refers to selling bonds of non-German corporations denominated in DM to a German audience.

foreign competitors would start offering products referring to German securities, for example equity options and bond futures (Simonian 1987). They also feared that cash markets could follow derivatives trading. The top firms—Deutsche Bank, Dresdner Bank, Commerzbank and Deutsche Girozentrale—thus set up a committee to study the matter. It soon found legal obstacles, including laws that banned futures trading dating from the 1930s.

Dresdner's chairman, as the head of the German Federation of Private Bankers, then sent the government an official wish list outlining the necessary regulatory changes. Hesitations notwithstanding, the government complied; one year later, most of the required legal changes were in force while the banks themselves worked out the regulatory details (Simonian 1988b). In the meantime, LIFFE had indeed announced the trading of Bund futures. All efforts—including those of the finance ministry itself—now concentrated on keeping business in the German family (Fisher 1988, Interview 020506). Deutsche Bank, in waiting for the DTB to become operational, went as far as renouncing LIFFE's contract to hedge its Bund exposures. The DTB venture proved successful over the following year, and by the mid-1990s, LIFFE's Bund contract had lost much of its significance.

One of the problems the DTB encountered was symptomatic of German finance at the time: the launch of the electronic exchange was followed by the question of trading screens in other countries (Lütz 2002: 237f). Foreign authorities, however, were concerned about the lack of a proper regulatory framework. For the DTB to thrive, many now concluded, German regulatory and supervisory structures had to be updated. The banks had had similar experiences in other areas after realizing in the second half of the 1980s that they needed foreign investors to fuel the German capital market business. The demand for (new) shares from the German public was likely to remain limited—in the 1980s, households invested no more than 1.6 per cent of their wealth in stocks (Story and Walter 1997: 173). Reforms to introduce transparency were thus not inspired by global structural pressures and a heightened competition for capital. Banks had a *commercial* interest in developing capital markets, and given the lack of a domestic customer base,

had to attract foreign investors (cf. Saunderson 1992).

The reform of national bourses followed a similar rationale. Compared to the US and the UK, securities markets were plainly underdeveloped—in effect the playground of a handful of large banks. Trading was done more over the phone than during the short opening hours of the eight regional stock exchanges. This fragmentation—eight bourses for an equity stock that stood at a mere 30 per cent of GDP, with the majority of shares not for sale—had been consciously bolstered by the large banks (Lütz 2003b). Blue chip shares were distributed over four markets—Frankfurt, Stuttgart, Düsseldorf and Munich. The remaining four bourses had been allotted shares to ensure their survival. The governing body for the eight exchanges, the *Arbeitskreis der deutschen Wertpapierbörsen*, took decisions unanimously. While this impeded change, it enabled a comfortable lack of competition.

To make German stock markets more attractive to outsiders, the large banks resolved to end the dispersed trading. Unsurprisingly, the push to concentrate business in Frankfurt was resisted by the other seven markets. In the struggle that ensued, public officials sided with the private actors closest to them: the federal finance ministry and the regional authorities responsible for Frankfurt supported the large banks; local authorities elsewhere backed ‘their’ exchanges. In the end, the Frankfurt coalition prevailed. The episode was typical of German regulatory politics in that it did not pit ‘the state’ against ‘the market’. Rather, facing each other were advocacy coalitions (Sabatier 1988) comprised of public and private actors.

Indeed, top-level working groups on financial reform included private sector representatives (*Handelsblatt* 1990). Such public-private cooperation was institutionalized in corporatist bodies such as the *Zentraler Kreditausschuss* (central credit committee, see Lütz 2003b: 122). Even if leading German banks were beginning to challenge the prevailing ‘conception of control’ (Fligstein 2001) in domestic financial markets, the most important competitive struggles still unfolded between national financial centres and the financial players wedded to them. After all, unlike in France and the UK, large domestic banks already dominated local securities markets.

Rather than prying open markets they had been excluded from, banks pushed an incremental reform programme whose cumulative effects nevertheless changed the financial landscape.

To sum up, the German financial system at the time was jointly managed by public and private actors. The ‘positive coordination’ of finance with national economic policy—monetary and industrial policy in particular—placed severe restrictions on admissible competition, particularly for foreign firms supplying services to German clients. National public and private actors enjoyed a structural correspondence of their interests. This correspondence was to disintegrate over the coming decade. But as long as it lasted, it supported institutional structures that allowed public and private actors to coordinate their activities for mutual benefit.

Regulatory reform in French state-led capitalism

The 1980s also witnessed the reform of capital markets in France. While the direction of reform was similar to that in Germany, the political process differed; the differences largely stemmed from the distinct varieties of capitalism that had evolved in the two countries. This not only meant national economic institutions faced distinct pressures and incentives to adapt to changes in the global economy; for this thesis, the *indirect* effects of these national varieties were as important. As a complement to general state interventionism and control of the economy, ‘state autonomy’ (Skocpol 1985) in financial market policy was higher in France than in Germany (Coleman 1996). The idiosyncrasies of French reforms were not only due to the specific character of French *economic* institutions, a line of reasoning common in functionalist comparative political economy (e.g. Hall and Soskice 2001b, Rajan and Zingales 2003). The historical development of French capitalism had produced specific *political* institutions that structured the policy process, and which influenced French reforms.

This section also reveals how misleading the distinction between private and public interests in financial market reform can be. The German case showed how private and public actors often rallied around common goals and confronted other public-private advocacy coalitions. In the French case, the public-private distinction is even less useful (cf. Coleman 1994:

48). After Mitterrand's nationalizations in the early and mid-1980s, most of the banking industry was in the hands of the state; brokers, known as *agents de change*, had the status of public officials (Cerny 1989). Little surprise then that capital market reforms in the 1980s were state-driven. Most political and economic power was somehow incorporated into the state's structure. In addition, the government directly or indirectly controlled two-thirds of listed companies (Graham 1989a). The Trésor, the directorate of the finance ministry responsible for financial markets, was the focal point of the domestic financial elite. Often graduates of the same school (Schmidt 1996: 299), many of its members spent time at the Trésor before taking top public positions or heading state-run or affiliated banks.⁷ Personal networks provided the social glue for the French policy community, even after formal links between the state and banks began to weaken.

Reforms were masterminded by the Trésor while the motivation was specifically French. Domestic financial markets were unable to provide sufficient credit for the economy. Neither in Germany nor in the UK did the need to attract capital play a central role in regulatory reform. After the breakdown of the final Bretton Woods system around 1970, the French moved from the post-war overdraft economy (the *économie d'endettement*) to the system of *encadrement du crédit* (Loriaux 1991: 38ff). This regime for allocating credit generated its own problems. Through attempts to keep inflation in check, some parts of the economy were chronically short of funds. No less than seventy special government-administered interest rate regimes in 1981 did little to help, but only compounded the problem (Coleman 1997: 279). After the socialist experiment in 1982 and Mitterrand's *grand tournant* the following year, the government resolved to overhaul financial markets.

Two aims of the reform programme stand out: the government wanted to end the micromanagement of credit allocation, the hallmark of the credit system, and to tap foreign sources of funding (Icard and Drumetz 1994). German financial reforms served as the template.

⁷ Think of Jacques Delors as European Commission president, Jean-Claude Trichet as head of the European central bank or Jean-Yves Habérier heading Crédit Lyonnais and Daniel Lebègue leading the Caisse des Dépôts et Consignations. Cf. Coleman 1996: 101f.

Universal banking in Germany had generated measured ‘competition’ between different kinds of financial players (savings, commercial and cooperative banks) in different market segments. It had further contributed to a more flexible allocation of savings. The anti-inflationary inclinations of the Bundesbank had also saved Germany the troubles France experienced in the years after the breakdown of Bretton Woods; even with growing capital mobility, it allowed the government to borrow at attractive rates. Being listed also enabled large companies to raise capital without indebting themselves. At the same time, the system of cross-shareholdings permitted coordinated industrial policy and a high degree of national control. Finally, universal banking had brought the big German banks balance sheets that allowed them to compete globally. The German model thus seemed to combine readiness for the new international situation with a degree of government discretion in economic guidance that the French cherished.

The Banking Act of 1984 tore down the barriers between the different segments of the credit market. Institutions ranging from the local *Caisses d’Epargne* to commercial giants like *Banque National de Paris* were to ‘compete’ and build their business where they saw fit. This did not mean that the allocation of credit was privatized: the same socialist government that introduced ‘competition’ between banks nationalised all but a handful of them. The conservative government that came to power in 1986 then reversed some of the nationalizations: *Paribas* was privatized the same year, *Société Générale* followed in 1987. The abolition of credit restrictions through the Banking Act now meant that banks needed fresh capital (Graham 1987a). Formal privatization was the means towards this end.

The bank privatizations were part of a larger privatization programme that fuelled the Paris stock market boom. Traditionally, French securities markets had played a subordinate role to banking proper—even more so than in Germany. Bank loans had often been subsidised by the state, making equity financing unattractive for corporations. Direct access to the bourse had remained the preserve of so-called *agents de change*, an oligopoly of stock brokers who enjoyed the status of government officials. In 1978, stock market capitalization stood at a meagre 9 per cent

of GDP (Graham 1987b). By 1985, this had risen to 13 per cent, still low compared to Germany's 24 per cent and 40 per cent in the US. Government privatizations had a decisive impact: in 1987, 3.8m people signed up for Paribas shares alone while the number of direct shareholders quadrupled due mainly to 14 privatisations that raised FFR72.5bn (The Banker 1988b). While enthusiasm waned in the wake of the global crash later that year, the seeds of a stronger equity culture had been sown.

Securities market reforms throughout the 1980s can be grouped under two headings: a general up-dating of the market, similar to what happened in Germany, and what was soon called the *petit Big Bang* on the Paris Bourse. In the first instance, reforms consisted of admitting new financial instruments. In the mid-1980s the government approved the introduction of certificates of deposit and commercial paper and loosened exchange controls, aware that Paris might otherwise become a 'financial backwater' (Coleman 1997: 275). It thereby succeeded to repatriate much securities business back to France, where many operations had hitherto not been possible (I. Walter 1988: 189). After all, BNP and Paribas had moved their capital market operations to London in light of the greater possibilities there (Graham 1987a).

The biggest innovation, however, was the *Marché à Terme d'Instruments Financiers* (MATIF), the new futures market opened in 1986. The MATIF was the brainchild of the Trésor and became an internationally recognized success, even as it started as an almost exclusively French affair (Graham 1987d, Story and Walter 1997: 214f). Of the 88 members in 1987, only one could count as truly foreign—American Express. The resolve to open the door to more foreign members was fed by the exchange's ambition to become a premier centre for the trade of ECU futures (Graham 1987d). As in so many other instances, liberalization was strategic and controlled in the interest of French market incumbents. The idea was to selectively allow foreign financial institutions into the French market, certainly not to integrate them in a homogeneous European financial space.

MATIF's soaring trade volumes generated great profits for the *agents de change* and sparked jealousy among the excluded banks. The latter wanted their own markets in futures contracts, rather than being obliged to go through the *agents de change*. With the conflict escalating, the banks referred it to the Trésor. Heavy state patronage notwithstanding, this struggle fits the pattern of competition politics found in other countries where credit institutions were pushing into hitherto closed securities markets (see Fidler 1987 for Canada, Sobel 1994 for the UK, the US and Japan). When the banks finally prevailed, the head of the stock exchange, Xavier Dupont, spoke of authorities having to put an end to the 'civil war' (Graham 1987c).

The struggle continued as the reform initiative passed to the private sector. A mere two years after the settlement, and much to the chagrin of the MATIF and its official sponsors, a consortium of French banks and a Swedish specialist set up a rival exchange, dubbed OMF (Graham 1989b). The sponsoring banks included BNP and Paribas—the two that had already broken ranks by setting up their capital market operations in London—and Crédit Commercial de France, privatised in 1987 (Graham 1988a). These cracks in the public-private front continued to widen as the direct links between the government and financial institutions weakened. But as in Germany, there remained a structural correlation between large banks' interests and those of public actors. For both, it still made sense to think in terms of 'national markets', to associate on that basis, and to form policy preferences accordingly.

The other aspect of French financial market reforms—those regarding the Paris bourse itself—was reminiscent of developments at the LSE. The Stock Exchange Reform Act of 1988 turned the *agents de change* into private enterprises and limited their brokerage oligopoly until the beginning of 1992 (Lehmann 1997). At the same time, legislation allowed the newly christened *sociétés de bourse* to raise capital from external sources—necessary if they were to trade on their own account. In effect, this meant that what had happened elsewhere was to be repeated in Paris: large financial players would buy themselves into the stock market by folding specialist firms into their own operations (Graham 1987b). By the end of 1990, close to 80 percent of the small

specialist firms had effectively been bought up.

The removal of bond trading from the stock exchange monopoly in 1987 was no less consequential: the market share of the large banks which would henceforth act as market makers surged to 73 per cent in the first half of 1988 (Graham 1988b). Again, French players got most of the action and were the prime beneficiaries of the 'liberalization' of the market. The development was of course hardly accidental. Up to this point, it closely followed the script written by the Trésor.

The reform of regulatory and supervisory structures informalised the closed-shop characteristics of the French policy community, but unsurprisingly failed to abolish them (cf. Coleman 1996: 97ff). In principle, the proposed structure again resembled the British model, featuring self-regulation plus a statutory body with punitive powers. Towards this end, the authority of the *Commission des Opérations de Bourse* (COB) was expanded, giving it a role not unlike that of the Securities and Investment Board in the UK (see Moran 1991). Only France approached the model from the other side. Here self-regulation was the new element, taking the form of the Conseil de Bourses de Valeur (CBV) for stock markets. CBV members were stock exchange firms.

'Regulatory competition' between financial centres was most palpable in the Paris bourse's rivalry with London's SEAQ International. The latter functioned as a hybrid between a conventional exchange and an information distributor. Operational since 1985 and fully automatic, it allowed market-makers—firms willing to buy and sell a specific range of shares—to quote their prices on a continuous basis, and make these prices known to other parties through the system. Deals would then be made over the telephone; physical trading floor had become obsolete.

By the end of the 1980s, this London-based system had attracted around 30 per cent of trading in French equities. Big players in particular liked the SEAQ because it facilitated trading large swaths of shares at stable prices, so-called block trades. French regulators had traditionally

limited block trading in the name of investor protection.⁸ In 1991, firms stepped up the pressure (Dawkins 1991b). The commission studying the matter was chaired by René de la Serre, head of *Crédit Commercial de France* (CCF) (Dawkins 1991a). A newly privatized second-tier firm, CCF was well positioned to criticize the government for dragging its feet. French top firms had themselves started to use the SEAQ and were ambivalent. When the report came in, the CBV quickly decided to facilitate block trading. But it did not go as far as some reformers would have liked (Rawsthorn 1992).

The authorities knew that the half-hearted measures would be insufficient to stymie the trading of French shares in London. At the same time, it remained unwilling to copy the SEAQ's model. Instead, they made the question of transparency in securities trading a central issue in European negotiations on the Investment Services Directive, a point we will return to in the following chapter. The episode makes clear, however, how the initiative for reform had begun to shift from the *Trésor* towards the financial institutions. The harmony of interests between financial institutions and public actors was showing its first serious fissures.

The French politico-economic elite continued to keep a close watch over the ability of foreign institutions to make inroads into the domestic market for financial services, and over the possibility of foreign control over important domestic FSPs. In France's case, Vogel's qualification of the reforms as strategic re-regulation is apt (S. Vogel 1996). As many scholars have noted, the centralized state enabled public actors to react swiftly to perceived policy challenges (Coleman 1996, Schmidt 2002). Widespread state ownership, and later patronage, of financial institutions helped. All the same, French authorities sensed they would be unable to compete with London unless they gave up their interventionist agenda and protectionism.

⁸ If a financial institution plans a large transaction it is eager to hide its intentions from the market lest prices move against it. It favours lower disclosure standards and a time lag for reporting trades to the authorities, who may publish the data. If financial institutions are allowed this degree of secrecy, however, they may use it to the disadvantage of particularly smaller investors. These investors hear of transactions that may hurt their positions only long after the fact. In addition, lower disclosure rules might encourage all sorts of market rigging and other collusive behaviour among participants.

European policy would thus become an increasingly crucial avenue to address hitherto international problems.

Regulatory reform in British market capitalism

Capital markets in Britain were likewise overhauled in the 1980s. The politics behind the reforms again differed from those in France and Germany. Such variation should not come as a surprise: the role of capital markets in the British economy differed from that in the continental economies. There was no interventionist economic policy within which capital markets played an important role, certainly after the Thatcher government took over in 1979. The lack of such positive coordination created room for actors other than the government to play key roles in market regulation, not least the industry itself. The flip-side of self-regulation was the institutionalized incapacity of financial firms to dominate government policy once capital market regulation appeared on the political agenda.

The reforms themselves have been well researched and documented (e.g. Moran 1991, Augar 2000). For the purpose of this thesis, two aspects deserve emphasis. First, domestic factors were central (cf. Sobel 1994)—regulatory changes can only be understood by referring to the specificities of the British state and the peculiar structure of the British financial industry at the time. As with Germany and France, this belies purely exogenous, ‘global’ pressures as the main force behind the reforms. Second, competition politics mattered. Once change was in the air, three clusters of firms emerged: established securities markets houses, British clearing banks, and foreign (investment) banks hitherto active in the offshore Euromarkets.⁹ Their conflicting interests clearly emerged in during the domestic reforms—and reappeared at the EU level in the years to come.

The capital market structures that have developed in the UK since the 1960s are probably unique in the world. By the mid 1980s, the City of London was playing host to the globally

⁹ Clearing banks are banks in the traditional sense: financial institutions involved in deposit-taking and lending. As in the US, they had been excluded from the securities markets business in the UK.

integrated Euromarkets and the top bracket of international financial institutions active there. Alongside the Euromarkets, the City also accommodated the national securities markets—including the London Stock Exchange (LSE)—dominated and controlled by traditional British merchant banks, stock brokers and jobbing firms (cf. Augar 2000). There was thus not one, but two Cities (Thompson 1997). While the names of those active in the Euromarkets twenty years ago still represent the top league of global finance, the names of the top British firms are now mostly forgotten.¹⁰

State guidance of the British economy through the financial sector was negligible (Zysman 1983: 171ff). There was virtually no public ownership of financial institutions while the relationship between the national industry and the clearing and merchant banks was an arm's length one. State involvement in the capital markets mainly functioned through the Bank of England, which had formal oversight powers. The Bank's role, however, was ambiguous. Nationalized only in 1946, it functioned as much as an advocate of City interests vis-à-vis Whitehall as the other way around (Ibid.: 200f). Direct government guidance was virtually absent.

The City functioned as an 'esoteric' club (Moran 1984a: 4). Market rules either took the form of industry self-regulation or informal 'gentleman's agreements' among firms or with the Bank of England. The LSE functioned as a members-only club; the execution of client orders and actual share trading were controlled by two oligopolies free to set their own rules. Other capital market functions, such as the issuance of securities, were handled by yet another group of firms, the merchant banks. Their oligopoly was slightly less formalized, but with the Accepting Houses Committee (AHC) the merchant banks had a body through which they could coordinate their activities and agree on common norms and rules. Because the government was barely involved in capital market policy, the firms' direct political connections with Whitehall were poor. The AHC, for example, did little in the way of serious lobbying (1984b: 177). Other financial

¹⁰ Think of the merchant banks Schroders, Hill Samuel, Samuel Montagu, Charterhouse and Robert Fleming (all among the top ten in 1982/83), the brokers Hoare Govett, James Capel, Scrimgeour Kemp Gee and Phillips & Drew (top four in 1983) and the jobbing firms Akroyd & Smithers, Wedd Durlacher, Pinchin Denny, Smith Brothers and Bisgood Bishop (top five in the same year).

sector associations that later rose to prominence such as the British Bankers Association (Filipovic 1997: 125ff) were not yet involved in capital market matters due to the separation of merchant and commercial banking.

The government's main concern was that the City, and the institutions within it, should thrive. The financial industry's economic role—in terms of employment, taxes and contribution to the balance of payments—was more important than its position in economic policy (on wealth-generation in the City, see Leyshon and Thrift 1992). This explains the government's relative indifference to the problems the 1980s capital market reforms created for British firms, and why the firms lacked the institutional power to do anything about it.

The history of the Big Bang—as the LSE rule changes of 1986 became known—differs markedly from what happened in Germany and France. The nickname reflects the magnitude of the changes the reforms triggered in the City's capital markets, but put in longer-term perspective, little about them betray a coherent government strategy. Two years after a change in its rules in 1976, the Office of Fair Trading (OFT), which was responsible for competition policy, more or less stumbled upon the cartel-like structures of the LSE (Moran 1991). Baffled by what it found, it referred the LSE's rule book to the Restrictive Practices Court for review. It complained about the single capacity system, fixed commissions and the restricted membership of the exchange (Sobel 1994: 37ff, S. Vogel 1996: 101ff). Unsurprisingly, the LSE and its members were reluctant to surrender their cartel privileges. In contrast to both France and Germany, there was no such thing as automatic government support for the financial industry. The legal proceedings started to run their course.

Almost certain of defeat, the LSE finally succumbed to the government's demands in 1983, one day before the court was to pronounce its ruling. Nicholas Goodison, LSE chairman, and Cecil Parkinson, head of the Department for Trade and Industry (DTI), struck a deal. Goodison promised to amend the LSE rule books in line with the DTI's requirements.

Membership was to become more open and fixed commissions would be abolished. In return, the ministry removed the LSE from the jurisdiction of the Restrictive Practices Court.

The initial referral of the LSE to the Restrictive Practices Court was exogenous to any financial market dynamics. But once the dispute broke out, other stakeholders quickly seized the opportunity to push their own agendas. Most importantly, the clearing banks saw their chance to break into a profitable market segment from which they had been excluded. Their efforts were successful. As a main component of the Parkinson-Goodison agreement, the LSE loosened restrictions for non-members to buy themselves into stock market firms, even though the Office of Fair Trading, the initial force behind the reforms, never voiced any complaints on this point.

It was the abolition of these restrictions that made the ‘sell-out’ of the old ‘domestic’ City possible. Even before October 27, 1986—the date of the ‘Big Bang’—most of the City’s stock market firms had lost their independence (Augar 2000). Twenty years later, a British securities industry worth its name no longer exists. In an ironic twist of fate, the British clearing banks that successfully opened British securities markets to outsiders paved the way for a third group of institutions to dominate the City: foreign investment banks. Of the British high street banks that dared to foray into securities markets, only Barclays still plays a significant role.

A spate of scandals in the years before and after 1980 fuelled the impression that informal self-regulation combined with winks and nods from the Bank of England would no longer suffice. The government commissioned a study—what was to become the Gower Report—on how market regulation could be updated. In his report, Professor Gower asked for greater government oversight of the SROs. Keen to preserve their independence, leading City firms opposed the plan, and with the help of the Bank of England, got their way (Moran 1991: 72). Instead of direct government oversight, the SROs came under the purview of a private organization, the Securities and Investment Board (SIB). In view of their fate over the past two decades, the confidence of British financial institutions in the mid-1980s and their dismissal of public oversight appear misplaced; greater participation by public actors may have worked in

their favour through patronage in times of crisis. Instead, the resulting cobweb of self-regulatory bodies generated few shared interests between the government and British securities firms, though they did generate ample confusion and frustration (Lascelles 1988b). A decade after the introduction of the system, it was abolished due to its deficiencies.

The UK reforms integrated the two ‘Cities’—the domestic markets and the Euromarkets (Thompson 1997). London’s openness since the early 1960s had made the provision of non-British financial services an important industry (cf. Helleiner 1994). Only one British firm, S.G. Warburg, played a significant role in these markets; most were American, Japanese, German or Swiss.¹¹ Their activities were deemed ‘offshore’, meaning that the financial flows of these markets remained outside the UK financial system (Burn 1999). The government did not to intervene in their affairs (S. Vogel 1996: 95). After all, continental banks alone employed almost 14,000 people in the City in 1988 (*The Banker* 1988a) and the industry was on the rise: since the beginning of the decade, the volume of international bonds had more than quadrupled, with the bulk of the activity going through London (I. Walter 1988: 3).

The Euromarkets functioned as an entrance to European markets for foreign firms. These firms—above all the American ones—also introduced a new business culture that was to spread throughout the continent: transaction banking. Hitherto all European financial systems had functioned on the basis of personal or institutional relationships. This was as true for the German Hausbank system as for the ‘gentlemanly’ capitalism that prevailed in the City. The American firms turned capital markets into sellers’ markets: they created demand for products where none had existed, poached clients from competitors and broke conventions to boost profits (cf. Partnoy 2002). As chapter five will show, this increased dynamism in financial services reached European firms in the 1990s and helped inspire their reorientation towards a liberal, transnationally integrated EU capital market.

¹¹ Cf. the league table for Euroequities for 1986 and 1987. While the positions vary between the two years, American firms dominate in both. Gardener and Molyneux 1990: 177. For an overview of Eurobonds, see *Ibid.*: 206.

When the domestic British debate over regulatory reform spilt over into the Euromarkets, participants there successfully kept public intervention at bay. In 1985, the top Eurobond underwriters created a new business association, the International Primary Market Association (IPMA), to fend off regulatory oversight (Urry 1985). Their bargaining position was strong: at the time, about three-quarters of global Eurobond activity was thought to go through London's markets—a business twice as large as the one in UK government bonds (Riley 1985). The Securities and Investment Board eventually appointed a weathered practitioner as director of international securities, Richard Britton of Drexel Burnham Lambert. Britton proved sympathetic to industry demands—for example, to allow 'stabilisation' in bond markets, a practice dismissed by many as simple market-rigging, and the 'soft commissions' of the leading UK investment bank at the time, S.G. Warburg (cf. Wolman 1986, Waller 1990, Waters 1991a). The IPMA was allowed to continue to write its own rules (Mügge 2006).

Domestic capital market reforms made the barriers between international and domestic industries more permeable. American firms in particular made use of the looser LSE rules to either set up their own operations or buy themselves into member firms (Augar 2000). The American firms were well adapted to competition since market restrictions on Wall Street had been eliminated in 1975. Their growing role in British markets quickly fed into the political arena as well.

As the market shares of the firms it represented fell through the mid-1980s, the Accepting Houses Committee—the de facto trade association of the British merchant banks—began to look like an anachronism. In 1987 it changed both its name and structure. Together with the former Issuing Houses Association, it was rechristened the British Merchant Banking and Securities Houses Association (BMBA) (Thomson 1987, Filipovic 1997: 128ff). Foreign members were introduced, though the voting power of non-EU firms was capped (Lascelles 1988a). Six years later, 'British' was removed from its name (Financial Times 1994). The BMBA became the London Investment Banking Association (LIBA), and is today one of the most

influential lobby groups in the field.

A closer look at the changes of the mid-1980s shows that despite ‘globalisation’, firms with a pan-European vision were few in number. Nevertheless, the face of the British securities industry changed fundamentally in the three years between the Parkinson-Goodison agreement and the Big Bang. The majority of the jobbing and broking firms were bought by merchant, investment and clearing banks jostling for position in the post-Big Bang era. But whereas British, American and Swiss firms tried to secure a piece of the broking and market-making pie, firms from other EU countries hardly budged. German and French firms, despite their well-established positions in the Euromarkets, were conspicuously absent from the first round of the sell-out, illustrating how the Euromarkets complemented the essentially domestic focus of these institutions. Insofar as domestic clients valued access to these markets, either as buyers or sellers of securities, large banks were expected to be present, functioning as bridgeheads between national clients and global markets. But, to take an example, French firms had no ambition to arrange deals between two British clients and thus penetrate the *domestic* UK market. Whereas the market for financial *instruments* showed clear signs of ‘globalisation’, the market for financial *services* retained distinct national biases—certainly in Europe (Corrigan 1990, cf. *The Banker* 1988a).

Conclusion: European state-market condominiums in comparison

Reforms in Germany, France and the UK bear the clear imprint of their respective varieties of capitalism, which had left their mark on business models and patterns of bank ownership just as political institutions and overall market structures. At one end of the spectrum, state control of the financial sector in France meant reforms followed a coherent plan and were (initially) dominated by state objectives. In contrast, the crucial Big Bang reforms in the UK began almost by accident; strategic objectives played a much smaller role. But as in France, market participants seized opportunities to improve their competitive positions wherever possible. At first sight, the German case seems to rest between the other two: strategic state objectives played a role, but

were not the driving force behind the reforms. What distinguished Germany from both France and the UK was the heavy influence of bank interests on regulatory change. Banks' organizational autonomy from the state, coupled with privileged access to policy-making, gave them more institutional power than their French and British counterparts. Table 1 summarizes these differences.

As the analysis has shown, the competitive concerns of domestic market incumbents shaped regulatory reforms. To be sure, these concerns depended on national market structures while their influence varied with domestic political institutions. State dominance in France meant that the competitive conflicts between *agents de change* and commercial banks only surfaced once privatizations began. In Germany the dominance of the universal banks within securities markets ameliorated competitive struggles between groups of market participants; they instead focused their energies on generating new business, both domestically and abroad. Finally, in the UK, the presence of the Euromarkets in the City allowed foreign firms to dominate domestic securities markets within a decade of the Big Bang—even though the original challengers to the domestic cartel had been British clearing banks.

Taken together, these reforms demonstrate how market incumbents' preferences were slowly shifting in favour of business internationalization, even if reforms remained strategic and dominated by national (business) actors and the market for capital market services remained fragmented along national borders. Banks providing purely domestic services in foreign countries remained rare outside of the UK. The politics surrounding securities markets in Europe in the 1980s could still be described in traditional terms of national policy communities, national markets, national regulatory regimes and international competition (though limited in the realm of services). These politics formed the domestic side of the international constellation, the European dimension of which the next chapter addresses. In these international negotiations, banks were to use the same institutionalized access to policy making that this chapter has exposed for domestic reforms.

Table 1	<i>Germany</i>	<i>France</i>	<i>United Kingdom</i>
<i>Market structures</i>	Foreign FSPs play negligible role.	Foreign FSPs play small role; higher than in Germany because the French current account deficit necessitates capital inflows and the presence of foreign FSPs to sell French securities.	Divided between a relatively closed and detached domestic financial system, including the LSE, and highly internationalized Euromarkets.
<i>Embeddedness</i>	High. Banks and system of cross shareholdings essential for industry policy; banks also play important role in monetary policy.	Very high. Financial system used to channel credit and for industrial policy. Extensive state-ownership of FSPs.	Low
<i>Relationship between public and private actors</i>	Cooperative. Public actors inclined to yield to private pressure.	Almost symbiotic. Top personnel move from government to banks and back with ease. Fissures start to appear in the wake of privatization in the late 1980s.	Mixed. No single discernible 'government' stance. Industry's relationship with BoE often cooperative, but relations with OFT and DTI more adversarial.
<i>Policy-making community</i>	Extensive industry self-regulation; contacts with public actors through common policy community for credit market.	Trésor at the helm; includes top-level bureaucrats and industry representatives.	Industry self-regulation; under indirect government oversight after the FSA.