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Leiden
The Netherlands

Introduction: towards a political economy of banking

Hardie, I.; Howarth, D.; Maxfield, S.; Verdun, A.

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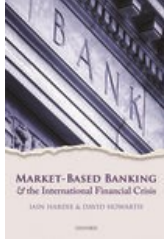
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CHAPTER

1 Introduction: Towards a Political Economy of Banking

Iain Hardie, Sylvia Maxfield, Amy Verdun

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Abstract

In this introductory chapter we first review the standard bank–credit/capital markets dichotomy used to describe national financial systems. We examine the influence of this dichotomy in the comparative political economy (CPE) literature, which is the disciplinary focus of most of the contributors to this volume. We explain how effectively scholars of the political economy of finance explain the phenomenon of change and then briefly describe the market-based banking model in the context of the broader national financial systems. In the penultimate section, we consider the impact of market-based banking on the domestic political economy and the impact of the international financial crisis.

Keywords: [political economy](#), [market-based banking](#), [financial crisis](#), [varieties of capitalism](#), [banks](#), [financial systems](#)

Subject: [Financial Markets](#), [International Financial Markets](#), [Banking](#), [Macroeconomics and Monetary Economics](#)

Introduction

The dichotomy that underpins most contemporary examinations of national financial systems distinguishes between the two main components: bank credit and capital markets. Financial systems have been analysed in terms of the relative presence of these two components by economists, political economists, and scholars in a range of disciplines and sub-disciplines. Very few studies have queried the analytical usefulness of this dichotomy. The operation of the financial system in terms of the relative presence of bank credit versus capital markets is then seen as having implications for non-financial companies (NFCs) and other elements of the national economy.

We argue that this dichotomized understanding of financial systems has contributed to the widespread intellectual incapacity to grasp the nature of changes to national financial systems and to explain, much less predict, the differential impact of the recent financial crisis on advanced industrialized economies. The aim of this volume is to demonstrate why an appreciation of the new activities of banks is crucial to understand the development of financial systems. We propose market-based banking as a model and analytical tool that can be applied to explain the development of national financial systems over the decade prior to the international financial crisis that erupted in 2007. By focusing on banks' choices about their business activities, we are able to pinpoint important drivers for change in national financial systems and the activities that contributed to the international financial crisis. The eight country chapters of this volume examine market-based banking in eleven countries, examining banking and financial system change and the impact of the financial crisis. We have selected a range of wealthier countries, including all seven of the former G7 'advanced industrialized' economies, covering the different types of financial systems and economic models. We have included countries which have been affected very differently during the financial crisis.

In this introductory chapter, we first review the standard dichotomy and examine its influence in the comparative political economy (CPE) literature, which is the disciplinary focus of most of the contributors to this volume. We next explain how effectively scholars of the political economy of finance explain the phenomenon of change. The subsequent section briefly describes the market-based banking model in the context of the broader national financial systems. We present the details of the market-based banking framework in the second chapter of this volume (Hardie and Howarth). In the penultimate section, we consider the impact of market-based banking on the domestic political economy and the impact of the international financial crisis.

The Political Economy of Finance

Differences in national systems of finance have been the object of study in several academic disciplines: in financial economics (for example, Allen and Gale 2000; Hackethal 2001; Schmidt, Hackethal and Tyrell 2001); economic sociology (for example, Krippner 2005); business studies (for example, Davis 1996; Davis and Steil 2001; Useem 1996); legal studies (for example, La Porta et al. 1998); and International Political Economy (IPE) (for example, Helleiner 1996; Pauly 1995; Strange 1988, 1996). Nearly all these studies assume the bank credit–capital markets dichotomy and its perennity. There was, prior to 2008, surprisingly little examination of developments in banking and the impact of these developments on national financial systems. A small body of literature in the sub-field of financial economics is a partial exception. See, for example, Rajan (1998) on the decreasing importance of commercial banks in the US financial system. Rajan and Zingales (2003) predict a limit to the development of market-based systems in European financial systems but see political factors as most relevant, ignoring developments in banking. A handful of policy makers and practitioners also analysed changes in banking (Gerald Corrigan 1982; Feeney 1995).

Over the past thirty years, the literature on the political economy of finance has started from the premise that financial systems shape the availability of capital to actors through differential pricing. The resulting access and pricing structure has economic and political implications. Differences in national systems of finance, however, have rarely been the primary object of study in CPE. CPE studies on banks and banking systems are particularly lacking, with a very small number of important exceptions (notably Deeg 1999).

p. 3 Rather, most CPE studies assume that the financial sector fits a standard depiction and then construct an analysis about the interaction of the assumed financial system with other elements of the domestic political economy—including state and non-state actors—and then analyse the resulting economic outcomes.

For comparative political economists, Zysman's (1983) *Government, Markets and Growth: Financial Systems and the Politics of Industrial Change* is the work of reference on the political economy of national financial systems. In his study, Zysman outlines three main varieties of financial capitalism (VoFC): government-led credit based, bank credit based, and capital market based. Zysman's (1983) main contribution was to show how these three varieties, depicted as relatively static, shaped the scope for government action and industrial development. Zysman's contribution was institutionalist in that he placed emphasis upon long-standing institutional structures that determine the policy alternatives open to both government actors and financial market operators. Since the publication of Zysman's book, the government-led variety has been reformed largely out of existence in developed economies, leaving scholars with the standard dichotomy (Culpepper 2005; Clift 2007). In credit-based financial systems, bank institutions play a central role in the economy intermediating between household savers and entrepreneurs. This system is seen as a core element of the variety of capitalism (VoC) found in Japan and many West European economies, notably Germany, and frequently labelled as coordinated market economies (CMEs) (Hall and Soskice 2001a). The capital market-based financial system is similarly a core element of another VoC, referred to as the liberal market economy (LME) (Hall and Soskice 2001a) and typified by the UK and the US. Although there has been more nuanced categorization of the varieties of capitalism typologies by identifying new types, such as mixed market economies (MMEs), (see, for example, Amable 2003; Hancké, Rhodes and Thatcher 2007; Whitley 1999; Wood and Frynas 2006), there has been very little effort in unpackaging Zysman's understanding of national financial systems as such.

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For Zysman and many comparative political economists, the contrast between market- and credit-based systems depends on a very specific role for banks as bulwarks against the influence of financial markets on NFCs. The banks' bulwark role is dependent on banks being suppliers of 'patient capital' to clients with which they have a relational, not arm's-length, interaction. Two economists, Rajan and Zingales (2003, 12), suggest that '[b]y its very nature, a relationship-based system does not pay much attention to market or price signals'. Crucially, in such a system, banks must be able to 'not pay much attention to market or price signals' (Rajan and Zingales (2003, 12). Banks 'draw their funds from deposits' (Zysman 1983, 61), depositors are loyal, and as a result banks have ready access to the funds they require for their lending. This is central to Zysman's typology and the more standard ↪ dichotomy. In contrasting 'a system based on capital markets with resources allocated by prices established in competitive markets' with 'a credit-based system dominated by financial institutions' (Zysman 1983, 55), Zysman is assuming, as many others implicitly have (for example, Rajan and Zingales 2003), that the capacity of banks in credit-based systems to themselves borrow would not change their dominant role. Zysman also does not consider the need for banks to have capital to support lending. The distinction Zysman makes is between financial agents and financial intermediaries (Zysman 1983, 57). Banks are agents in terms of their lending decisions, whose financial power allows them to influence the pricing of credit in an economy. Financial institutions that act as intermediaries in the provision of bond and equity financing merely reflect the relevant market's pricing of that financing.

Central to the bank-based system, and to the existing dichotomy, is therefore banks' 'financial power', derived from the fact that 'a limited number of financial institutions dominate the system' (Zysman 1983, 72).¹ Unless 'the movement of prices in the markets reflects [the] concentration of market power' (Zysman 1983, 72), the bank-based/capital market-based distinction is largely meaningless, because the movement of prices in bank lending would be determined by the market in the same way as the prices of other financial assets. We argue that this is now generally the case in bank lending, although to a different extent across the countries the following chapters analyse. In reality, banks acting as agents in terms of their business models have undermined their 'financial power' in lending to NFCs. Banks have increasingly turned themselves into market intermediaries in these lending activities.

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Banks are seen as potentially supplying two kinds of patient capital: long-term holdings of equity or long-term bank loans. Importantly, Zysman emphasizes both, and the interaction between the two. When Hall and Soskice (2001b) published their book, CME banks were already selling down their shareholdings (Hall and Soskice 2001b, 23) and expanding their business activities (Hall and Soskice 2001b, 62). Yet CPE scholars writing on NFC finance in CMEs have largely insisted on the persistence of bank lending as 'patient'. They emphasize the continued importance of relational banking in CMEs, allowing 'access to capital independent of current profitability' (Hall and Soskice 2001b, 16), most notably in the archetypal bank-based financial system, Germany (Hall and Soskice 2001b, 62; Vitols 2004; Deeg 2010).² Such systems have persistently high aggregate bank lending in NFC finance (Vitols 2004; Deeg 2010). We argue that this claim of continued patient lending is problematic. It implies that the changing activities of banks do not have an impact upon their role as patient lender ↪ to NFCs. The argument depends on banks being able to lend long term and to continue to support their NFC clients regardless of market pressures on the banks themselves. We argue that this view of banks as bulwarks against market pressures has become inaccurate, and relies—in contrast to extensive analysis of the changing nature of equity financing—on a static conception of banks and loans and an unwillingness to consider in detail this area of financial markets.

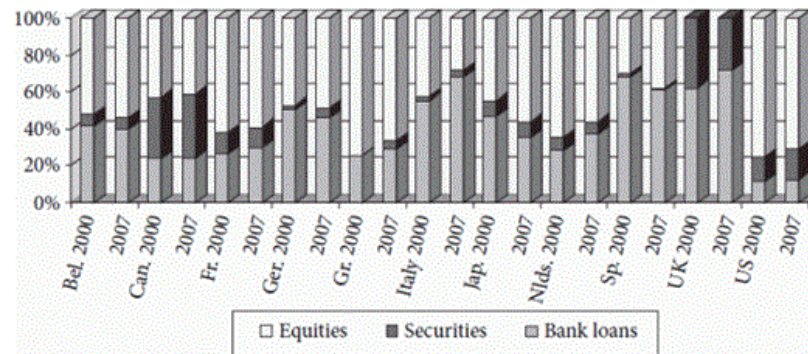
Our focus on banks and lending, and on the rise of market-based banking, highlights a crucial source of change which undermines 'patient capital'. Market-based banking inherently undermines the central position of 'relational' house banking by increasing the position of market considerations relative to long-term investment considerations in bank business decisions. Of further importance is that the rise of market-based banking potentially affects corporate governance in small and medium-sized enterprises (SMEs), which depend more heavily on bank financing than larger firms that tend to have more diversified funding, including equity. Examples of such SMEs would include the German *Mittelstand*, whose unchanged financing sources are emphasized in the debate on CME change (Deeg 2010).

The VoC literature rests on the importance and nature of equity financing, and often untested assumptions that the discipline imposed through dispersed equity ownership and take-over threats in capital market-based financial systems squeezes out labour protections, social welfare policies, and a host of other social, political, and economic characteristics. The key causal mechanism in this literature stems from the concentration or dispersion of share ownership, which is examined closely (Gourevitch and Shinn 2005), revealing significant cross-national variation. Patient equity capital (whether held by banks or other long-term investors) is a core observable feature of CMEs and it allows national political economies to maintain their distinctive VoC rather than converging on the liberal market model (Schmidt 2002; Culpepper 2005). The continued viability of this institutional diversity hinges on the ability of coordinated financial systems, such as those in Germany and Japan, to shield company managers from the short-term imperatives characteristic of liberal market economies (Culpepper 2005). Generally, the examination of national financial systems was not in the mainstream of the VoC literature, which has maintained a more narrow focus on the welfare state component of national systems of capitalism or labour relations within the state (see Hicks 1988; Hall and Soskice 2001a; Hancké, Rhodes, and Thatcher 2007).

Crucially, when we consider the recent financial crisis, the depiction of national financial systems originating with Zysman and the ‘dichotomous framing’ employed in the VoC literature does not fit the character of national financial systems in the 2000s. Banks (measured in terms of assets) increased their presence in national financial systems at the expense of equity in the large majority of advanced industrialized economies—including the LMEs. Trends in NFC financing further question existing depictions. The rise in both bank lending and bank assets to gross domestic product (GDP) were most marked in the supposedly model LME, the UK.³ Indeed, the result left the Bank of England highlighting ‘the potential benefits of lowering the economy’s reliance on bank finance’ (Bank of England 2009a: 11). Furthermore, in a range of other countries that had seen a previous shift towards capital market-based capitalism—notably France and the Netherlands—the direction was reversed in the 2000s. An examination of NFC external funding is provided in Figure 1.1 and Table 1.1. Here, we see the increased reliance of NFCs on bank lending in both real and relative terms in the seven years preceding the financial crisis in six of the eleven countries studied in this volume.

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Figure 1.1.



Non-financial company finance (bank loans, securities, equities) as a percentage of total (2000 and 2007)

Table 1.1. Non-financial company finance (bank loans, securities, equities) 2000–7 (per cent increase/decrease, end of year)

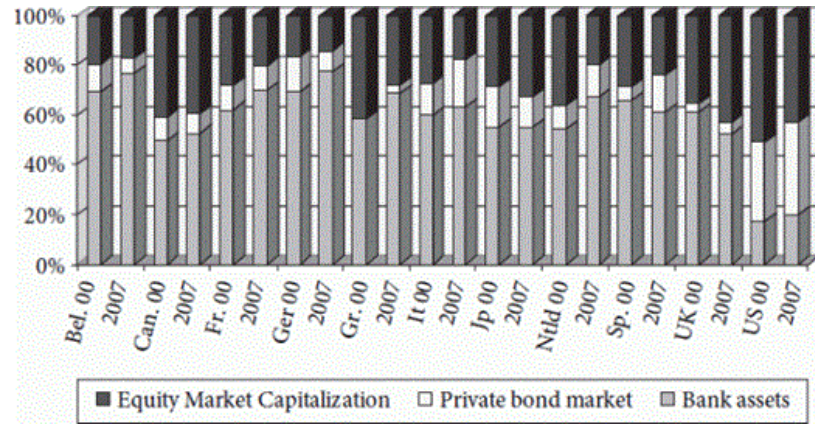
	Lending Increase %	Securities Increase %	Equity Increase %
Belgium	20.7	25	32
Canada	26	38.5	27.4
France	45.6	18	21.5
Germany	5.2	123	17.9
Greece	63.1	325	29.6
Italy	62.8	190	-12.8
Japan	-28	2.5	21
Netherlands	45	6.3	3.5
Spain	42.3	-2.2	201.6
UK	74.9	40.3	N/A
US	51	59.6	24

Sources: See Figure 1.1.

p. 7 The data in Figure 1.2 and Table 1.2 provide the second principal method of distinguishing between national financial systems by focusing upon the relative amounts of bank assets, private sector securities, and equity markets (as in Allen and Gale 2000). Here the increased real *and* relative size and importance of banks in national financial systems is indicated in *all* the countries except one (Japan⁴). However, rather than interpreting these data in terms of a return to the more bank-based financial systems of the past, we argue that it is necessary to understand banking and financial markets as intertwined. It is precisely this intertwining that lies at the heart of the financial crisis, as the following chapters make clear.

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Figure 1.2.



National financial systems (2000 and 2007):

Table 1.2. National financial systems, bank assets, private debt market, equity market capitalization to gross domestic product, 2000–7, percentage increase

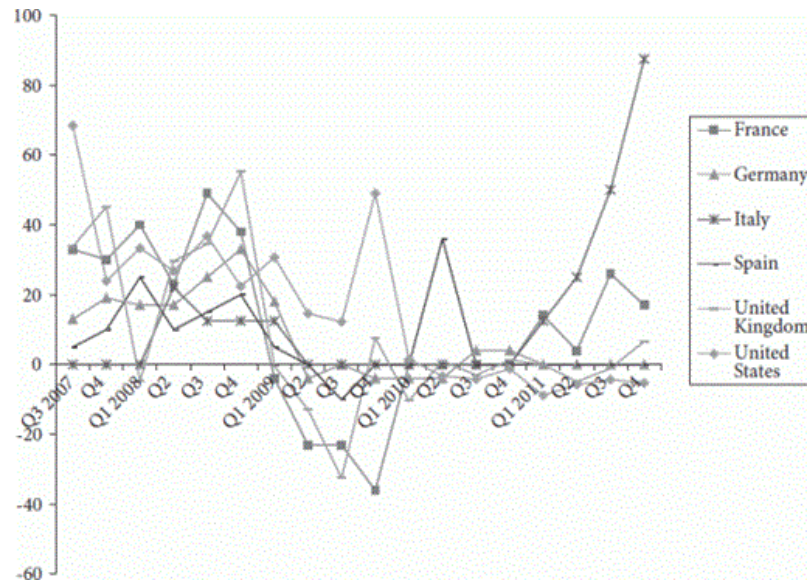
	Bank assets increase	Private bond market increase	Equity market capitalization increase
Belgium	39.1	-29	10.4
Canada	43.4	15.4	29.4
France	43.2	23.7	-7.7
Germany	4.5	-43.9	-20.5
Greece	2.7	3400	-40.2
Italy	17.3	68.6	-26.8
Japan	10.3	-18.7	27
Netherlands	48	57.4	-33.7
Spain	52.1	295.9	35.6
UK	49.2	19.4	-26.5
US	17.9*	23.3	-12.2

*Commercial banks' lending figures only.

Sources: see Figure 1.2.

This intertwining is discussed more fully in the next chapter (Hardie and Howarth), but we make here one observation regarding the factors influencing bank lending to NFCs. Figure 1.3 shows figures for the tightening of bank lending to NFCs from mid-2007 (the intensification of the financial crisis) to the end of 2011 due to the ‘cost and availability of funding’, that is the ability of banks to borrow to fund lending.⁵ This is a reason that Zysman’s conception of banks as funded by stable deposits, and therefore as bulwarks against market pressures on NFCs, cannot envisage (absent a deposit run), yet it made a significant contribution to the tightening of bank lending conditions—a credit crunch—in all the countries examined. In the UK the ‘cost and availability of funding’ was almost as significant as the more nebulous ‘expectations about economic activities’.⁶

Figure 1.3.



Tightening of bank lending due to ‘cost and availability’ of funding

Sources of Change in the Political Economy of Finance Literature

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Most of the CPE literature that invokes a role for financial systems in advanced industrial economies does not pay attention to differences among national banking systems. Recently, the institutionalist literature on capitalism has begun to explore sources of change in domestic political economies, but none focus, as this volume does, on banks’ choices about business activities. In contrast, banking business has been construed as a source of change in the IPE literature to a much greater extent than in the CPE literature. In particular, as the nature of international financial markets changed after the 1970s with significant growth in global markets, IPE scholars made these changes an object of study and explored the way change in international financial markets shaped domestic political economy (Andrews 1994; Pauly 1988; Abdelal 2007). Political economy studies of financial market integration also focus on the actions and responses by individual states to these challenges (see, for example, Deeg (1999) on Germany; Katz (1998) on Japan; Loriaux (1991) on France, and Verdun (2000) on Britain, France, and Germany).

While dichotomous positioning is still characteristic of the CPE of capitalism, the literature includes a recent turn to exploring sources of change. Streeck (2004) focuses upon the role of governments, and Hall and Thelen (2009) theorize about the role of both governments and firms. A longstanding research stream at the intersection of CPE and management studies explores the way that NFC preferences and operations explain shifts in national capitalism and associated institutional characteristics (Whitley 1992, 1999; Guillén 2001; Aguilera and Jackson 2003; Crouch 2005; Hancké and Goyer 2005).

p. 10 As the CPE literature begins to theorize sources of change in national capitalism and market institutions, the time is ripe to investigate sources of change in financial institutions and systems and correct the long-standing tendency to take the financial system as an invariant part of an explanation for other aspects of the domestic political economy. A small number of CPE scholars have placed emphasis on the agency of domestic actors in shaping national financial system change (Crouch 2005; Deeg 2007; Jackson and Deeg 2008). Busch (2009) and Deeg (2005) focus on the importance of governments in shaping financial systems through regulation and supervision. Parallel to this are studies by economists focused on the impact of regulation upon the behaviour of financial sector agents (see, for example, Hellmann, Murdock and Stiglitz 2000; Barth, Caprio and Levine 2006; Leaven and Levine 2009).

Government actions shaping national financial systems extend beyond regulation narrowly defined to 'industrial' or 'sectoral' policy that amounts to protecting certain financial business sectors from competition and/or encouraging development in new arenas. O'Sullivan (2007), for example, depicts the crucial role of the French state in directing financial market reform and driving the creation of the domestic bond market (see also Howarth, this volume). Similarly Posner (2005, 2009) outlines the role of the European Commission in pushing the creation of European stock markets. Other CPE scholarship aims to explain sources of change in national financial systems, emphasizing NFCs' funding strategies or bank–NFC interactions as the independent variable (Culpepper 2005; O'Sullivan 2007; Erturk and Solari 2007; Deeg 2010).

Generally, comparative political economists have not examined the role of bankers themselves as an autonomous and primary driver of change in national financial systems, as we do here. This is curious, given the importance of banks to most financial systems in providing a significant proportion of NFC external finance—even in the Anglo–American systems. The market-based banking model introduced here focuses on a particular set of business activities banks chose increasingly in many advanced industrial economies beginning in the late 1990s. The sources of dynamism in this volume are the choices of bankers about their business activities, and the aspects of the broader environment that shape those choices.

The chapters in this volume emphasize the role of banks as agents: making business decisions, engaging (or not engaging) in financial innovation, and responding to their own experience in the market (including their experience with global liquidity and previous banking crises) and not just as institutionally embedded actors (Crouch 2005; Hall and Thelen 2009). Nonetheless, the chapters that follow varyingly highlight one or more of six different institutional factors shaping bankers' business choices: banking regulation (including capital stringency), banking supervision, corporate governance rules, fiscal (including tax) policy, the structure of other financial institutions in place (notably equity and bond markets), and protectionism in the banking sector (both direct and indirect forms). There is overlap here: notably protectionism is often achieved through corporate governance rules and fiscal policies. In their depiction of these different considerations that may underpin bankers' choices about business activities, the chapters in this volume rub elbows with several other streams of research, such as the literature on the political economy of regulation and supervision (Pagano and Volpin 2001; Underhill, Blom and Mügge 2010; Quaglia 2011). Regulation and supervision can reflect the previous history of banking crises (Busch 2009; Royo, this volume; Kamikawa, this volume). Another related arena of inquiry addresses the impact of corporate governance structures on the behaviour of financial institutions (Barth et al. 2006). For example, Laeven and Levine (2009) point to riskier behaviour for banks where shareholders have more say.

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National capital and regulatory regimes have shaped banking activities and have been widely perceived as the principal factors contributing to the impact of the financial crisis. However there are limits to the regulation, supervision, and corporate governance explanations for bankers' choices. The data produced by Barth et al. (2006) on capital stringency and bank regulation show the diversity of regulatory practice in our case countries and Table 1.3 juxtaposes these data with different levels of write-downs on financial assets and public funds drawn upon by banks in the financial crisis until 2010. Regulation is a moderately good predictor of the crisis with regard to Italy, Greece, and Spain, where market-based banking levels, especially with regards to assets, were comparatively low, in part because of capital stringency and regulation, and the direct impact of the financial crisis on banking systems limited. Clearly, however, as the relevant chapters make clear (Pagoulatos and Quaglia, this volume; Royo this volume), subsequent events have undermined even this moderately good prediction. However, regulation alone is anyway less useful in teasing out the differences with regard to other countries where scores are similar (as with the Netherlands, Germany, and France), but the forms of market-based banking and the impact of the financial crisis are considerably different. Such a superficial focus on regulation most obviously fails to predict the impact of the financial crisis on the US (see Hardie and Maxfield, this volume). One might criticize the values the authors assign to regulatory regimes, not the relevance of regulation *per se*. One might also recommend a more specific analysis focused upon national rules on the kinds of financial activities that contributed to the crisis: notably, off-balance sheet activities and securitization. However, it remains that several other factors contributed to the different levels and forms of market-based banking in national banking systems. Kamikawa's chapter on Japan is particularly noteworthy in this regard. He shows not only how low market-based banking limited the impact of the crisis on Japan's banks, but also how Japanese banks retreated from

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market-based banking as a result of Japan's own crisis in the late 1980s and subsequent 'lost decade', and despite continued financial deregulation.

Table 1.3. Capital and bank regulation, write-downs and public support (2007–10)

	Belgium	Canada	France	Germany	Greece	Italy	Japan	Netherlands	Spain	UK [‡]
Capital stringency*	NA	4	2	1	3	4	4	3	4	3
Restrict[†]	NA	7	6	5	9	10	13	6	7	5
Securities write-downs as a % total bank assets (2007)	0.44 (08–09 only)	0.84 (07–09 only)	0.38 (7/07 to 4/10 only)	2	0.012 (07–09 only)	0.086 (07–09 only)	0.22, (April 2009 est.)	1.8	0.17	0.52
Public funds drawn upon by banks (% 2007 GDP) by end 2009	6	0.5	1.1	4.9	0	0.3	0.2	2.5	1.1	6.5

*Capital stringency is an index of regulatory oversight of bank capital. This index is based on the following questions: is the minimum capital asset ratio requirement risk weighted in line with the Basel guidelines? Does the minimum ratio vary as a function of market risk? Are market values of loan losses not realized in accounting books deducted from capital? Are unrealized losses in securities portfolios deducted? Are unrealized foreign exchange losses deducted? What fraction of revaluation gains is allowed as part of capital? Are the sources of funds to be used as capital verified by the regulatory or supervisory authorities? Can the initial disbursement or subsequent injections of capital be done with assets other than cash or government securities? Can initial disbursement of capital be done with borrowed funds? Thus, capital stringency does not measure statutory capital requirements. Instead, it measures the regulatory approach to assessing and verifying the degree of capital at risk in a bank (Laeven and Levine 2009: 263).

[†]Restrict is an index of regulatory restrictions on the activities of banks. ‘This index measures regulatory impediments to banks engaging in securities market activities (e.g. underwriting, brokering, dealing, and all aspects of the mutual fund industry), insurance activities (e.g. insurance underwriting and selling), real estate activities (e.g. real estate investment, development, and management), and the ownership of nonfinancial firms’ (Laeven and Levine 2009: 263).

[‡]Figures for the UK are not provided in the original study but are reproduced in Laeven and Levine 2008.

Sources: Barth et al., 2006 for the figures on capital stringency and banking restrictions. National Central Banks, 'Financial Stability Report' and IMF Global Financial Stability Report, April/October 2010 for figures on securities write-downs and public funds drawn.

Table 1.3 also demonstrates the ambiguous correlation between the development of market-based banking, the impact of the financial crisis and traditional categorizations of varieties of (financial) capitalism. For example, in LMEs—notably the UK and US—market-based banking had developed further than most other national economies and the economies were hit particularly hard and early during the financial crisis. Similarly, the so-called MMEs of southern Europe—Greece, Italy, and Spain—developed less market-based banking and were far less affected during the early stages of the financial crisis, but have become a focus of attention later. There are also several cases where banking activities and the impact of the financial crisis do not conform to the VoC—thus several CMEs, including Belgium, Germany, and the Netherlands, were hit very hard by the financial crisis which has been otherwise associated with LMEs. Similarly, it can be added, LMEs including Australia and Canada suffered little (Porter 2010; Leblond 2011; Leblond, this volume). This lack of a clear correlation—demonstrated clearly by the eleven country cases analysed in this volume—suggests the need for a new way of analysing and distinguishing financial systems and one that provides an explanation of change.

Even in the cases where tight bank regulation corresponded initially to limited financial crisis, there remain significant differences in banks' engagement with the market. Market-based banking is multifaceted, and potentially involved both asset and liability sides of a bank's balance sheet. This influences both the nature and timing of the impact of the crisis. The Spanish central bank, for example, was widely praised for the regulation that limited banks' use of the off-balance sheet vehicles that caused bankruptcy at some German banks (see Royo this volume; Hardie and Howarth, this volume). However, Spanish banks were highly market based on the liability side of their balance sheets, especially in relatively high levels of securitized borrowing (that is, banks transforming loans into asset-backed securities (ABS)) which contributed to the property market bubble in that country. Thus, while the financial crisis did not have a devastating direct impact on most Spanish banks, the collapse in demand for ABS had a knock-on effect on Spanish bank lending, the bursting of the asset price bubble, and a seemingly rather more 'traditional' banking crisis.

An understanding of what shapes the extent to which bankers embrace different kinds of products or lines of business activity must take into consideration the broader range of variables outlined here. The chapters in this volume do not, however, test these variables formally. The focus is upon the activities of banks. However, most if not all of the variables are discussed in each of the chapters as relevant, to contribute to a more complete understanding of national financial, and specifically banking, systems. We argue that the level and form of market-based banking provide a better guide to the impact of the international financial crisis upon different countries than regulatory framework or political economy type. In the next chapter, we place national banking systems on a scatter plot graph and on a continuum, the position on which correlates more closely with the impact of the financial crisis.

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The Impact of Market-Based Banking on the Domestic Political Economy

The chapters of this volume focus in detail on describing banking activity and the impact of the financial crisis, and secondarily on some of the factors that shape bankers' choices about the extent to which they engage in market-based banking. However, in addition to economics, our analysis of banking is also relevant to political economy and political science for its impact on social groups and governments. The starting point for our discussion of the ways market-based banking might impact upon the real economy, different stakeholders, and government, is how financial institutions make profits. The literature on varieties of capitalism implicitly suggests that financial institutions have two possible business models. In one model predominant in bank-based or credit market systems, financial institutions make loans at higher interest rates than they pay on deposits. The banks intermediate between household savers and entrepreneur borrowers and, usually, homeowners. Banks' 'funding base' in this system is household deposits, and banks are 'price setters' in the interest rates they pay to depositors and charge borrowers. In the second model which predominates in the capital market-based system, financial institutions underwrite initial stock or bond offerings and are fee-taking brokers buying and selling those stocks or bonds for retail or institutional customers and, usually, trading those stocks or bonds for 'the house' (the financial institution itself). In this system, financial institutions intermediate between saver-investors and entrepreneurs, with the financial institution as a price-taker earning a small fee for intermediation.

In the third model evident in the chapters included in this volume, financial institutions rely on the market to enable their lending in a variety of ways. To varying degrees in our different country cases, this business model exists alongside the more traditional business models. In this market-based banking, banks and other financial institutions themselves borrow to finance their own lending, often in complex ‘production’ chains of financial assets. As a result of that chain, a bank or financial institution intermediates between a saver and a household or entrepreneur borrower by making a loan, but the ‘saver’ is increasingly another financial institution investing through the market. In addition, another financial institution—most infamously AIG—may provide credit insurance (at a market-determined price), thereby assuming the credit risk inherent in the loan. This is a credit-driven model, but the loan originator, unlike the classic bank-based model, is less and less likely to be dependent on deposit-taking. In this model, commercial banks increasingly depend on borrowing and hedging from financial markets for their lending, and parallel banks, any financial institution that lends but does not take in deposits (and therefore does not ordinarily enjoy lender of last resort support from a central bank), have taken on a share of the loan origination business of commercial banks. These parallel banks are almost totally dependent on the market to finance their borrowing and determine the price of their lending.

The political economy of each system differs in simple but important ways. In the credit market-based system the major risk is borne by the banks in the unlikely case of a run by savers who withdraw deposits. In the capital market-based system as conceived in the existing VoC and VoFC literature, the financial institution pushes off risk of failure in the enterprise sector to the investing public. The main locus of risk in this system is the failing NFC enterprise (see Hardie and Maxfield, this volume).

In the third business model outlined in this volume, the financial institution transforms debt into investment by intermediating between debtors and investors who are predominantly other financial institutions. Pooling of underlying receivables in the creation of securitized assets appears to lower risk. Helping with this risk lowering are insurance companies. The entrepreneur from outside the financial sector is not a major focus in this business model. The main locus of risk is, as in the classic credit-based system, the financial institution. It faces the risk of a new type of bank run caused not by depositors but by other, much more skittish, financial institutions.

In this volume we label this third business model as market-based banking. This is closest to Aglietta and Breton (2001, 437), who recognize the change from a bank-based to a more market-based financial system, which they link to financial liberalization and financial innovation resulting from technological advance. They also recognize how banks add a ‘new market portfolio’ to their ‘traditional credit portfolio’ (Aglietta and Breton 2001, 441; see also Froud, Leaver, and Williams 2007). This market-based activity involves a range of activities: derivatives trading and investment in complex securities; raising funds on the wholesale markets (inter-bank borrowing, issue of securities, etc.). Securitization is an advanced form of market-based banking: the financial technique through which a financial institution converts assets (e.g. mortgages or other loans) into tradable instruments (such as ABS or asset-backed commercial paper) which financial institutions can sell off to raise financing. This permits these institutions to reduce the size of their assets and therefore reduce their solvency (leverage) ratio (assets/capital) and meet international and/or European guidelines. Securitization enables a financial institution to offer more lending or purchase other assets. Securitization also involves ‘shadow banking’—that part of the financial system that is absolutely or partially off the balance sheet of banks only because of the availability of market funding (Pozsar, Adrian, Ashcraft, and Boesky 2010). The business model also includes, crucially, the market financing of banks’ balance sheets; in other words, the ‘traditional credit portfolio’ has become less traditional, as it is financed by the market rather than deposits.

In economies where the third business model defined above increasingly dominated bank strategy and market-based banking spread, there was a rapid expansion of credit which fuelled significant growth in the financial sector compared with the non-financial sector and a dramatic increase in financial sector profits in both real and relative terms. The expansion of financial assets and more specifically bank assets since the 1980s has been dramatic and the expansion in the seven years from 2000 to 2007 quickened (see Table 1.2). The flip side was that where this business model increasingly dominated, governments faced increasing implicit liabilities associated with the threat of bank runs initiated not by depositors but other financial market actors, including other banks.

NFCs and households enjoyed more and lower cost options to borrow at arm's length from financial institutions thanks to supposedly risk-reducing loan pooling. As long as debt levels were sustainable and risk was genuinely dispersed in the financial sector, this system could permit consumption smoothing for households and investment smoothing for NFCs. This market-based consumption and investment smoothing was however a boon to governments only as long as it was sustainable. Incumbent elected politicians in several of our countries presumably benefited from the positive political pocket-book effect of consumers being able to use their houses as automatic teller machines but they took a drubbing when the boom went bust. While equity issuance may expose NFCs to greater short-term pressure than traditional relationship-based bank borrowing, the new market-based credit financing potentially exposed NFCs to greater volatility than equity-based financing. Kroszner, Laeven, and Klingebiel (2007) show how credit-dependent sectors grow faster in normal times and are hit harder in tough times.

Conclusion

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This chapter started by pointing to the inability of economics and political economy to explain the differential impact of the financial crisis on older developed economies. We traced this inability back to the 'dichotomous framing' of financial systems dominant in economics which has underpinned the typologies with which many scholars have been working. This volume offers ↪ a complement to the traditional typology of financial systems by looking at the activities of banks. In particular we propose a market-based banking model as an analytical tool to explain change in national financial systems.

The importance for CPE of the focus of this volume on banking lies in three areas. First, banks are central to Hall and Soskice's (2001a) categorization of CMEs and LMEs, even though 'bank based' is not a term they use in their seminal chapter (2001b) and banks receive little attention. Second, our approach serves to highlight an underappreciated aspect of change within financial markets: the changing activities of the financial market actors themselves. While this has particular relevance within the CPE literature, where change at the level of market actors has focused on NFCs, it has more general relevance to the study of finance, incorporating the level of detail most commonly found in the financialization literature. Third, market-based banking provides CPE a vital tool not only to explain the differential impact of the financial crisis but also to examine critically the logic behind government policy responses.

Our application of market-based banking also challenges claims of convergence in contemporary capitalism by demonstrating the non-static nature of the 'Anglo-Saxon' model to which other varieties are seen as converging (if only in part). While we reject the notion of a teleological evolution toward a new hybrid-type system, we do see some common elements of market-based banking developing—more or less—in the eleven national financial systems examined in this volume. The bank-based/CME and the capital-market/LME categories provide no helpful indication of the relative presence of these elements. Overall these elements highlight a potentially profound shift that calls for reframing. Although it is not the focus of this volume, our analysis of market-based banking could be combined with the two other forms of market-based corporate financing—bonds and equities—to give an overall assessment of the extent to which NFC financing and the financial system depends on market influences, and therefore the degree to which each national financial system is market based.

Financial systems evolve and change: they do not necessarily conform to the stylized facts of any single type. The addition of market-based banking and the factors that it identifies helps us to depict financial institutions and analyse their evolution because they describe a way that financial intermediation can occur that has not been previously understood in political economy scholarship. Introducing a new model and considering it across a variety of cases can help scholars be more accurate in their depictions of finance and its implications for varieties of capitalism. An understanding and application of market-based banking can help scholars who want to understand the role of banks in national economies generally, as well as providing insight into the financial crisis that erupted in 2007. This is what we understand to be a major contribution of this volume to the literature on the political economy of finance.

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Notes

- 1 A further pillar of banks' 'financial power' is therefore a lack of competition between banks (see Byrne and Davis 2003; Rajan and Zingales 2003; Lall 2006).
- 2 This view of the continued importance of the Hausbank to German NFCs is also challenged by some academics, e.g. Beyer and Höpner (2003).
- 3 Table 1.1 does not include figures for outstanding equity issuance by British NFCs because these data are not collected. Rather Bank of England and London Stock Exchange data cover annual flows (rise in equity issuance on an annual basis).
- 4 The Japanese exception (where NFCs have relied increasingly on equity issues and a significant drop in borrowing from banks) reflects in part the limited engagement with market-based banking by Japanese banks (see Kamikawa, this volume). Total bank lending also dropped in Japan.
- 5 These data are not available for the Netherlands, Belgium, Canada, and Greece. Japanese banks reported no tightening of bank lending conditions for reasons linked to cost and availability of funding.
- 6 UK credit conditions survey data show that cumulative tightening due to the 'cost and availability of funding' over the six quarters from mid-2007 to end 2008 was 233.4, while cumulative tightening due to 'expectations about economic activities' reached 235.8 (Bank of England 2009b).