Comment

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This paper summarizes and extends the authors' recent research on financial systems (see, e.g., Rajan and Zingales (2003a) and (2003b)) and applies the analysis to the European financial system. The first section starts by considering the state of Europe's financial system around 1980. At that time, Continental Europe had much less developed financial markets and a more concentrated and important banking sector than the United States. During the subsequent two decades Continental Europe's system changed dramatically. There was a significant increase in the importance of stock markets as measured by the ratio of stock market capitalization to GDP. Equity issues and the number of companies listed also converged to U.S. levels.

The second section compares the advantages and disadvantages of relationship oriented bank-based systems with arm's-length market-based systems. It is argued that bank-based systems may be better at some times such as early on when a country's economy is beginning to develop. At other times, such as when the economy is more advanced, market-based systems may be better. The beneficial role of the revelation of information and the financing of innovative industries in market-based systems is stressed.

The third section considers the political economy of financial markets. It is suggested that many vested interests wish to discourage the availability of finance because finance helps encourage competition.

The fourth section investigates the related issue of the relationship between political institutions and markets. Among other things it is argued that central banks are likely to discourage the development of financial markets because they make the achievement of their goals such as the conduct of monetary policy more difficult.

The final section considers the past, present and future of the European financial system. Its main focus is on how Continental Europe fell behind the United States before 1980 and how this can be prevented in the future.

The basic structure and themes of the paper can be summarized as follows.

1. The U.S. market-based system is compared with the Continental European bank-based system.
2. Both systems have advantages and disadvantages but ultimately the U.S. market-based system is superior particularly for advanced economies. Market-based systems lead to more information being revealed and are better at financing innovative projects.
3. The most important determinant of the form of a country's financial system is politics and in particular vested interest groups.
4. Central banks are likely to be antagonistic to financial markets.
5. Continental Europe fell behind the United States in the period after the Second World War and has only caught up since 1980. It is important that Europe does not fall behind again.

I will discuss each of these in turn.

Theme 1: The United Kingdom is mentioned at the beginning of the paper when it is lumped together with the United States as having a market-based system. Through most of the rest of the paper it is only mentioned in passing. This is a pity since it represents an interesting contrast to the United States and to Continental Europe. It has a longer history of financial markets and a rather different one than the United States. It is only in the last two or three decades that financial markets have been regulated by the government. During the nineteenth century when the London markets played such an important role in financing industry and governments throughout the world, there was very little explicit regulation. The Bank of England seems to have played an important role in encouraging the development of markets. This is perhaps because when it was originally founded in 1694 its original aim was to raise money to fight the French and markets were an important means of accomplishing this objective. In fact during the eighteenth century the London markets were primarily markets for government debt. The U.K.'s banking system is also very different from that in the United States . It is quite concentrated and has been for some time. It is interesting to note that U.K. banks have not lobbied against the development of markets over the long run.

Theme 2: The paper is very careful to be balanced about the advantages and disadvantages of market-based and bank-based systems. However, ultimately it is clear that the authors believe that a market-based system is significantly superior to a bank-based system for modern economies. They stress the information advantages of markets. Stock prices provide signals that allow funds to flow to their most valuable use. Allen and Gale (2000a; Ch. 7) have suggested that offsetting this allocational effect is the fact that more informative prices lead to more price volatility and hence risk. As in Hirshleifer (1971), this risk from more information may lead to a reduction in welfare. As an empirical matter it is not clear whether the allocational role of prices or the price volatility effect dominates. More research is needed on this topic.

Theme 3: The issue of what determines the structure of a financial system is an important one. The authors argue that the main determinant is politics and in particular, vested interests. They suggest that finance is viewed with skepticism by incumbent firms. These firms can finance themselves internally and only occasionally need to access external finance. However, potential competitors will be able to use sources of finance to establish themselves and threaten the positions of incumbents. The result of this will be that finance is not liked. This is particularly true of market finance where this effect of financing competitors may be more pronounced because markets are more competitive. Oligopolistic banks with long-term relationships with incumbents will be less willing to finance entrants since this will damage these relationships.

The United Kingdom provides an interesting illustration where politics do not appear to have played an important role in determining the form of the financial system. Incumbent firms and banks do not appear to have been able to lobby successfully for restrictions on markets. While in the United States it can be claimed that banks were dispersed and there was a strong political tradition of restricting their power, this was not the case in the United Kingdom .

Theme 4: If politics is of primary importance, what is the role of political institutions in determining the structure of the financial system? The authors argue that central banks play an important role and they are inherently likely to be anti-market. There a number of reasons for this. Similarly to Stigler (1971), it is argued that the central bank is likely to be captured by the industry it regulates. Perhaps more importantly the authors suggest it will be easier to conduct monetary policy and ensure financial stability in a bank-based system.

Again the United Kingdom provides an interesting counterexample to this line of argument. As suggested above the Bank of England has by and large not been anti-market. If anything at least for long periods it seems to have been pro-market. It would be interesting to document examples where central banks in other countries have been explicitly anti-market in their actions.

Theme 5: The authors argue that it is important that Continental Europe should not again be allowed to fall behind the US as it did in the period before 1980. They suggest that there will be strong forces that will try to cause a reversal and reduce the importance of markets.

It is an interesting question whether in fact the Continental European countries with their bank-based systems did in fact "fall behind" the US market-based system. During the period after the Second World War until 1980 the Continental European countries outperformed the United States and United Kingdom in most economic dimensions. In particular they had much faster growth rates. It is not clear that they were "behind" at this stage. As argued in Allen and Gale (2000a) a comparison of bank-based and market-based financial systems is complex. Each system has advantages and disadvantages. These must be considered in a long run context. A period of twenty years or so is too short especially given that most of this period consisted of an economic boom. For example, the U.S. economy did well in the 1920's while its stock market boomed. It did much better, in fact, than bank-based systems. It also did much worse during the 1930's after the Great Crash of 1929.

The basic perspective of the paper is that markets are superior for advanced economies. The natural transition is from a bank-based system, which is superior at an early stage of development, to a market-based system. However, this may be prevented by political forces and in particular the power of incumbents who have a vested interest to suppress the competition that would result from new firms that would be able to obtain finance from markets. From this perspective the important thing for Europe is to resist the pressures against markets and to continue to move towards a market-based system.

Allen and Gale (2000a; Chapter 2) give an alternative perspective on the development of financial systems. They suggest that asset price bubbles are the result of market failures. When bubbles burst there is a reaction against markets. This leads to regulation that reduces their importance. The regulation is often ineffective and leads to a misallocation of resources. After some time has passed and the inefficiencies associated with inappropriate regulation become clear there is financial liberalization. This allows bubbles to reemerge and the cycle repeats itself. From this perspective the problem is to correctly analyze the nature of the market failure associated with bubbles and to prevent them from arising or at least to minimize their negative effects. Allen and Gale (2000b) suggest that bubbles can arise from the combination of an agency problem and central bank policy that leads to too rapid an expansion in credit. In this view it is the responsibility of the central bank to try to prevent bubbles by avoiding the rapid expansion of credit.

In conclusion, this paper is an important contribution to the debate on how Europe's financial system should move forward. It contains many interesting ideas and should be widely read.

References

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