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GUEST EDITOR'S INTRODUCTION

The Design of Financial Systems and Markets

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There is a great variety of financial systems across different countries. Most countries have both financial markets and banks but the relative importance of these differs. At one extreme, countries like the United States have "market-based" financial systems where financial markets play an important role and banks are less significant. At the other extreme, countries like Germany have "bank-based" systems where banks dominate credit allocation and financial markets are not very important. Moreover, securities exchanges and trading systems also vary greatly across different financial systems, with attendant implications for market microstructure differences. Understanding the advantages and disadvantages of these differences is an increasingly important topic (see Allen and Gale (1994, 1999a) and Thakor (1996) for overviews).

Why do different countries have such different financial systems? Do their economies have different needs, resources, and technologies that require different financial systems? Are different financial systems performing different functions or do they constitute different ways of doing the same thing? Can we say that one system is "better" than another?

It is often suggested that the current trend is toward market-based systems. As a matter of policy, France has deliberately chosen to increase the importance of financial markets since the mid-1980s. Japan is undertaking a "Big Bang" reform of its financial system to make it more efficient and enable the Tokyo markets to complete with those in New York and London. The European Union is moving toward a "single European market," which will increase competitiveness and exposure to financial markets. Latin American countries, such as Brazil, are implementing changes to create U.S.-style financial systems.

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Why are so many countries, with different histories, environments, and populations seeking to converge to a single financial paradigm? Is there any reason to think that financial systems based on sophisticated, competitive financial markets dominate all others? What form of trading systems and rules should markets adopt to maximize their effectiveness? Should banks be universal and allowed to undertake all activities or should there be a separation between investment and commercial banking?

The papers in this Special Issue consider a range of the issues raised by the design of financial systems and markets. Levine (1999) looks at the fundamental question of whether the form of the financial system matters in terms of influencing economic growth. His answer is that it does. The paper brings together two important strands of recent literature. The first was pioneered by Laporta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998) and considers the relationship between the legal environment and the financial system. The second is concerned with the relationship between financial systems and growth considered among others by King and Levine (1993a, 1993b). The particular focus of Levine (1999) is how the legal and regulatory environment affects financial intermediary development and whether there is a causal link between financial intermediary development and economic growth. He finds that greater priority given to creditors, greater enforcement of contracts, and better information disclosure lead to more developed intermediaries. In addition there is a positive connection between financial intermediary development and long run economic growth and this link is economically large.

Schmidt, Hackethal, and Tyrell (1999) consider the nature of the transformation of the financial systems of France, Germany, and the United Kingdom over time. It is often suggested that as European financial integration proceeds, these countries' financial systems are converging and becoming more market-based with banks playing a less important role. The authors use National Accounts Data to investigate these issues. They find that there is not a general trend toward disintermediation. Only in France has there been a persistent move away from banks toward financial markets. However, the nature of intermediation has changed in all three countries. Securitization has occurred in all of them. Banks have tended to specialize in lending operations and relinquished their role as mobilizers of funds.

Allen and Gale (1999b) consider the normative issue of whether financial markets or intermediaries such as banks are better at providing finance for projects where there is diversity of opinion such as in the development of new technologies. The diversity of opinion considered arises from differences in priors rather than differences in information. The advantage of financial markets is that they allow people with similar views to join together to finance projects. This will be optimal provided the costs necessary for each investor to form an opinion before investment decisions are made are sufficiently low. Finance can be provided by the market even when there is great diversity of opinion among investors. Intermediated finance involves delegating the financing decision to a manager who expends the cost necessary to form an opinion. This type of delegation turns out to be optimal when the costs of forming an opinion are high and there is likely to be considerable agreement in any case. The analysis suggests that market-based systems will probably lead to more innovation than bank-based systems.

Finally, Alexander and Peterson (1999) consider the Uptick Rule on the NYSE. The rule is supposed to restrict short sales to situations where the stock price is rising and to prevent short sales from continually lowering the price and accelerating the fall. It is interesting to note that the London Stock Exchange and the Toyko Stock Exchange do not have a similar rule. Alexander and Peterson (1999) find that the difference between the effects of the Uptick Rule in advancing and declining markets is small in the sense that the rule prevents short selling in both cases. It thus violates one of its stated objectives of not impeding price discovery in rising markets.

As countries increasingly consider whether their financial systems and markets should be kept the same or reformed, the analysis of the kinds of issues discussed in this Special Issue will become more important. Many questions remain to be investigated and it is likely that this area will become a very active one in the next few years.

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