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Bank regulation and the process of internationalisation: A study of Japanese bank entry into London

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(Received 12 May 2008; final version received 8 September 2008)

The paper provides a theoretical insight into bank regulation and the process of internationalisation by examining the concepts of regulatory push and market pull within the context of Japanese bank entry into London during the 1980s. Rugman and Verbeke's [(1998). Corporate strategy and international environmental policy. *Journal of International Business Studies*, 29(4), 819–833] Consistency of Home and Host Government Goals model is utilised to structure the discussion, which centres on a situation where there is a conflict of goals between multinational enterprises (MNEs) and the home government but goal alignment between MNEs and the host government. As such the paper examines a relatively under-researched aspect of internationalisation and concludes that in certain circumstances internationalisation can occur despite great 'psychic distance'. The paper also argues that although bank regulation can lead to a conflict situation it can also be conducive to the development of a strong home base and the development of firm specific advantages.

Keywords: internationalisation; regulatory push; market pull; Japanese banks; city of London

Introduction

Most research into the determinants of bank internationalisation have focussed on the USA as the host country (Budzeika, 1991; Grosse & Goldberg, 1991; Hultman & McGee, 1989) and others have examined the foreign activities of banks from one home country throughout the world (Buch & Lapp (1998) on German banks; Yamori (1998) on Japanese banks, and Moshirian & Van der Laan (1998) on German, UK, and US banks) but relatively few studies have focussed on the UK (Fisher & Molyneux, 1996) and none to our knowledge have focussed exclusively on Japanese banks entering the UK.

Accordingly, this paper examines the entry of Japanese banks into the UK during the 1980s. The period in question was chosen for a number of reasons but principally the 1980s marked the end of an unprecedented period of deregulation within the UK, which commenced in the late 1960s with the full disclosure of bank profits and arguably culminated with the so-called Big Bang in 1986 (Hall, 1987). The 1980s, therefore, represents the end of a lengthy period of deregulation which liberalised the competitive activities of banks in the UK. This was in stark contrast to the situation in Japan, where the financial services sector was highly regulated. Moreover, this period also witnessed a significant influx of Japanese banks into the City of London. For example, the Japanese banks

doubled their total assets in the UK from 13.5% (£59,964 million) in 1980 to 26.6% (£241,683 million) in 1986. In the remaining part of the decade Japan's market share declined slightly but at 22.9% (£281,992 million) in 1989, this still represented a significant overseas presence in the UK.

In order to structure the discussion, the paper utilises Rugman and Verbeke's (1998) analytical framework, which examines internationalisation through the interactions of multinational enterprises (MNEs), with home and host governments. Rugman and Verbeke's (1998) conceptual framework was adopted because it builds upon and develops the neoclassical normative approach of Caves (1996) in a number of important respects. For example, it recognises that in the modern-day global economy the vast majority of country states have 'open' economies. Individual countries can, therefore, typically find themselves acting as both home and host nations to MNEs and this consideration can sometimes make it difficult or even counterproductive to introduce specific country level policies and regulations. Another important consideration in the adoption of Rugman and Verbeke's model is the fact that it implicitly rejects the neoclassical environmental economist viewpoint that regulation can only act as a constraint on firms because it essentially detracts from profit maximisation.

Instead, Rugman and Verbeke (1998) embrace the Porter and van der Linde (1995) argument that regulation can promote competitive enhancing change by forcing firms to adopt innovative solutions to problems present in their competitive and external environment. In this respect, it follows that regulation as a key determinant of the external environment can be an important influence in the direction of innovation. However, Porter and van der Linde (1995) recognise that the form of regulation is important, and in order to maximise the opportunities for innovation they advocate that regulation needs to be as flexible as possible. Accordingly, it is interesting to note that although regulatory controls in the Japanese banking sector were relatively restrictive they did not prevent Japanese banks from internationalising and responding to the market pull pressures presented by London's more liberalised deregulated markets.

Another consideration in adopting Rugman and Verbeke's model was the fact that it embraces the resource-based theory of the firm and, therefore, goes a step further than Porter and van der Linde, who have a tendency to emphasise the primacy of the external environment over internal firm characteristics (Hilliard, 2004). Rugman and Verbeke, therefore, explicitly recognise that many large MNEs develop a diverse range of firm specific advantages (FSAs), which in some instances can be determined by the external environment. The response to regulation and innovation opportunities will also be largely influenced by these firm specific capabilities. Nevertheless, despite these considerations Rugman and Verbeke's model does not fully take into account the effect that the external environment has on the decision to internationalise.

Rugman and Verbeke's framework consists of four quadrants, which incorporate various aspects of conflicting and complementing goal alignment between national governments and MNEs. Quadrant 3, which forms the focal point of the paper's discussion, depicts the situation where MNE's goals are in conflict with the home country but are complemented by the host country. Rugman and Verbeke (1998), however, claim that it is incorrect to assume that MNEs, which experience a conflict of goals with their home governments, will enter into host countries where goal complementarities are prevalent. Accordingly, the authors of this paper, mindful of the dearth of academic literature on quadrant 3 and Buckley and Casson's (1998) call for more critique of existing theory, argue that when 'regulatory push' and 'market pull' are in co-existence, Rugman and Verbeke's (1998) assertion will not apply.

The paper, therefore, focuses on quadrant 3 and provides greater insight into the process of internationalisation by examining Japanese bank's entry into the UK during the 1980s. An understanding of the meaning of internationalisation is crucial to the discussion and the following definition by Ramachandran, Mukherji, and Sud (2006, p. 292) is adopted: 'entering a new market that is geographically distinct from the home market. This is risky as the environment in a foreign country might pose unanticipated commercial and political challenges'. This definition is useful because it identifies the key themes of the paper, which inter alia incorporate the main differences between countries, the risks involved in entering different economic and political environments and the importance of good management to the long term success of MNEs.

The paper is organised as follows: the next section consists of a literature review on internationalisation and the twin concepts of regulatory push and market pull. This is followed by an examination of the empirical research on regulation and other determinants of bank internationalisation. The next two sections outline the main regulatory and deregulatory measures in Japan and London during the period under discussion. This latter section also discusses the origin and subsequent growth of the Eurocurrency market and the emergence of London as a financial centre. Rugman and Verbeke's Consistency of Home and Host Government Goals model is then presented and the effects of regulatory push and market pull on bank internationalisation are then discussed within this framework. The conclusion identifies the main arguments of the paper, contrasts these arguments with the views and findings of other academics and provides some rational explanation for the arguments postulated in the paper.

Internationalisation

Internationalisation is a multifaceted process, which involves inter alia, behavioural, economic and political considerations. It seems reasonable, therefore, to take the attitude of regulators into account when examining the subject. Accordingly, academics, such as, Bauer (1994), Dunning (1997), and Weiss (2005), for example, have contended that regulatory protectionism leads to internationalisation because it essentially constrains domestic competition and causes 'regulatory push', whereby firms seek more profitable opportunities in less regulated countries. Constraints on domestic competition are also generally regarded as promoting inefficiencies and some governments have, therefore, deregulated their national markets in an attempt to resolve economic problems and encourage growth and internationalisation (Chang, 2004; Sapienza, Autio, Geage, & Zahara, 2006).

In contrast, Dunning (1997) and Kolte (2006) have argued that high levels of regulation can 'condition firms' and lead to the emergence of 'leaner and fitter MNEs', which are better able to penetrate global markets. Similarly, Cheney (2006) has shown how high levels of regulation in the US securities market has fostered efficient domestic financial institutions and reduced the entry of less efficient foreign firms.

In order to obtain a more comprehensive understanding of why firms internationalise, it is also important to examine 'market pull'. A fundamental tenet of market pull is that firms will expand into foreign countries in order to pursue profitable opportunities (Bauer, 1994). As such, it is in accordance with Friedman's (2007) argument that the actions of managers are constrained and dictated by shareholder's desire for profit maximisation. Market pull is, therefore, predicated on the belief that firms are behavioural, self-interested actors that undertake strategic interactions with their environment (Rugman & Verbeke, 1998). Accordingly, Buckley and Casson (1998) and Anderson (1993), etc., have argued that efficiency and profit maximisation are principally determined by the

actions of home and host governments, which shape the environment and, thereby, determine the behaviour and propensity of firms to internationalise.

The process of internationalisation, however, is only partly explained by the behavioural approach and a range of other factors need to be considered. For example, it has been argued that internationalisation is conducive to greater firm stability and increased profitability because it spreads risk over a broader spectrum of operational markets (Bauer, 1994). Other considerations include accessing new markets and having a presence in the so-called centres of excellence (Westney, 2006). It is also widely acknowledged that firms internationalise in order to acquire additional resources, particularly, in the form of knowledge and experience, which can then be transferred back to the home country (Anderson, 1993; Sapienza et al., 2006). Yang, Leone, and Alden (1992) adopt a slightly different approach and focus on internal constraints, especially, the attitude of management towards exporting and comparative advantages. Closely related to the behaviour of management is the strategic entrepreneurship approach, which emphasises the importance of corporate culture, management competence, internal processes, and systems, to the process of internationalisation (Ramachandran et al., 2006). These sorts of considerations determine not only the willingness of managers to internationalise but also their ability in terms of planning and flexibility (Lumpkin & Dess, 1996). Flexibility is regarded as important because it determines a firm's so-called 'fungibility', i.e. its ability to transfer resources to alternative uses (Rugman & Verbeke, 1998), and its propensity to respond and survive (Buckley & Casson, 1998).

Another explanation of why firms internationalise is provided by Caves' (1982) Process Theory. In general terms, the theory states that firms make additional commitments in small incremental steps and, therefore, internationalisation can be regarded as an evolutionary process (Anderson, 1993; Channon & Jallan, 1979). The theory incorporates the concept of 'psychic distance', which asserts that firms expand to neighbouring countries that are culturally, politically, and economically close to the home country (Westney, 2006). In instances where large psychic distance pervades, the risks associated with internationalisation increase proportionately and this leads firm to adopt a home country or regional focus (Ramachandran et al., 2006). However, as Westney (2006) points out, firms do not always fit neatly into the Process Theory. Similarly, Anderson (1993) believes that internationalisation models are vague and lack explanatory power as to how or why internationalisation takes place.

Regulation and other determinants of bank internationalisation

In order to ascertain the affect that government regulation has on the process of bank internationalization, it is necessary to examine the empirical evidence (for a comprehensive coverage of this literature, see Berger, DeYoung, Genay, & Udell (2000)). In this respect, it is useful to make a distinction between developed and developing countries. Evidence relating to developed countries is provided by Focarelli and Pozzolo (2000) whose study of 143 banks in 28 OECD countries found that government restrictions on domestic banks detracted from internationalisation. A possible explanation might be that government restrictions reduce the efficiency of banks and, thereby undermine their comparative advantages compared to competitors in host markets. This explanation is supported by the findings of Barth, Caprio, and Levine (2001, 2004) whose cross-country study revealed that restrictions placed on domestic banks adversely affected performance and stability. Similarly, many studies have found that foreign bank's in the USA are less efficient than domestic banks because of the relatively high levels of regulation in their

home markets (Chang, Hasan, & Hunter, 1998; De Young & Nolle, 1996; Hasan & Hunter, 1996; Mahajan, Rangan, & Zardkoohi, 1996).

In contrast, recent cross-country studies that have examined the entry of foreign banks into developing countries have found that they are generally more efficient than domestic banks (Barajas, Steiner, & Salazar, 2000; Denizer, 2000). A possible explanation is provided by Mathieson and Roldos (2001), who argue that the difference between the findings for developed and developing countries reflect differences in conditions at the time of foreign entry. For example, they contend that most studies of developed economies cover periods when banking controls have been liberalised for some considerable time. Accordingly, domestic banks have had time to get used to competing with other banks across a wide spectrum of financial activities. This competition typically places pressure on profit margins, which forces banks to reduce costs, diversify risks and seek alternative sources of revenue (Kumbakhar, Lozano-Vivas, Knox Lovell, & Hasan, 2001).

Conversely, studies in developing economies have generally focused on periods when the banking system has only recently been liberalised or emerging from a crisis. In these instances, domestic banks have been protected from foreign bank entry and have experienced relatively low levels of competition from their domestic counterparts. Accordingly, protective measures detract from competition and protect inefficient banks. However, when markets are deregulated, significant profit making opportunities can arise, which attract more efficient foreign banks from developed countries. In the long term, however, some studies have revealed that under these circumstances foreign bank's entry can improve the efficiency of domestic banks (see e.g. Barajas et al., 2000; Claessens, Demirguc-Kunt, & Huizinga, 2000; Denizer, 2000).

There is, therefore, evidence to suggest that foreign banks invest in foreign countries to exploit profit opportunities and that this can bring about an increase in the overall efficiency of the financial system of the host country. However, in order to exploit profit-making opportunities it is imperative that banks look for countries with particular characteristics. Accordingly, Claessens et al. (2000) and Yamori (1998) found that foreign banks are attracted to countries with relatively low taxation and high per capita income. Focarelli and Pozzolo (2000) also found that foreign bank entry was higher in countries with relatively higher rates of economic growth. Similarly, there are some studies that link foreign bank entry to private foreign direct investment in the non-financial sectors (Ball & Tschoegl, 1982; Brealey & Kaplanis, 1996; Yamori, 1998).

This latter evidence has been used to support the contention that there is a 'pull' factor and banks follow their customers abroad in order to retain business. However, although this is an undoubted factor in the internationalisation of banks, it has also been argued that foreign bank entry drives private foreign direct investment in non-financial sectors. For example, research by Seth, Nolle, and Mohanty (1998) into the lending patterns of US-based banks from Japan, Canada, France, Germany, the Netherlands, and the UK, during the period 1981–1992, revealed that in the majority of instances loans were made to non-home country borrowers. Accordingly, they concluded that the 'follow the customer' hypothesis might not be as universally applicable as previously thought.

Another explanatory reason for bank internationalisation revolves around the question of size. Tschoegl (1983), for example, examined the world's largest banks in 1976 and found that there was a direct correlation between banks size and global spread. Grosse and Goldberg's (1991) study of foreign banks in the USA in the 1980s, also established that there was a relationship between the sizes of the home country's banking sector and internationalisation. A study by Ursacki and Vertinsky (1992), which examined foreign banks in Japan and Korea, Williams (1998), which focussed on foreign banks in

Australia, similarly found a positive correlation between asset size and number of foreign branches.

It could be argued that larger banks are more likely to have MNEs as customers and, are, therefore, more likely to be 'pulled' to new foreign locations. However, an equally compelling argument could be that banks with large home market shares might have greater 'push' incentives to seek risk diversification opportunities abroad. Similarly, benefits in the form of economies of scale might be associated with large-scale international banking (Vander Venet, 1996).

Regulation of the Japanese banking sector

The regulatory regime in Japan prior to the 1980s was pervasive throughout the entire economy but no more so than in the financial services sector. For example, in the case of depository institutions restrictions were placed inter alia, on their sources and use of funds, the terms of their lending and borrowing activities, i.e. yield, maturity, minimum denominations and collateral requirements, etc; the size of their branch networks, merger activities and their stake holding in other companies. Similarly, restrictions on the Yen as an international currency ensured that the authorities maintained total control of the foreign exchange markets. Consequently, Japanese banks were not subject to free-market forces and, therefore, inefficient banks were protected, innovation was stifled and fees well in excess of international levels became the norm (Mora, 2005).

In many respects, the Japanese banking system was historically similar to the UK's, with the Bank of Japan being solely responsible for note issuance. Under the direction of the Ministry of Finance (MoF), the Bank of Japan typically used direct controls to control the economy and achieve its monetary policy objectives (Hall, 1993). However, this somewhat inflexible approach, which also existed in the UK prior to 1971, restricted competition and enterprise within the Japanese banking system. Nevertheless, despite the constraining effect of direct controls they continued well into the 1980s on the basis that they represented the best method for maintaining the stability of the Japanese financial system (Vogel, 1996).

In addition to direct controls, the regulatory authorities also placed emphasis on moral suasion, statutory law and demarcation of the financial services markets: in essence, moral suasion is a form of administrative guidance (the so-called *gyosei-shido*) but it involved applying pressure rather than persuasion to obtain compliance from the banks. Tsutsui (1999), for example, commented that the MoF used moral suasion more than any other Japanese ministry and because it was the most powerful of all the Japanese ministries, it was in a position to impose sanctions for non-compliance (Williamson, 1995). Accordingly, Japanese corporations and banks in particular, regarded the ministry as a 'straight jacket', which restricted domestic economic growth.

Interest rate regulations reduced the Japanese bank's propensity to indulge in interest rate competition (Düser, 1990; Vogel, 1996). The main statutory instrument relating to interest rate control was the Temporary Interest Adjustment Law (TIRAL), which was implemented just after the Second World War. For almost 30 years, until it was eventually abolished in 1975 on anti-trust grounds, it regulated upper and lower limits on the interest rates private financial institutions could charge (Düser, 1990). A positive result of this regulation was that it helped to control inflation (Hall, 1993) and reduced the likelihood of bank failures (Mora, 2005). Hoshi and Kashyap (2001), however, argue that restrictions on price competition detracted from profit maximisation and banks attempted to alleviate this problem by increasing the size of their businesses. The Japanese regulatory authorities

reacted by placing restrictions on financial institution's ability to increase the size of their businesses and permission to expand branch networks, for example, had to be obtained from the MoF (Mora, 2005). Crucially, however, the regulation of Japanese interest rates was similar to Regulation Q in the USA, which together with other restrictive monetary policies resulted in American banks entering Europe and London in the 1960s (Einzig, 1970). Likewise in Japan, TIRAL eventually created regulatory push and was partially responsible for significant levels of Japanese bank investment in London during the 1980s.

The regulatory authorities were also responsible for the demarcation of the Japanese financial services industry and effectively determined the type of business that could be undertaken by financial institutions. As with the regulation of interest rates the demarcation of the financial system was implemented to minimise risk but it similarly reduced competition and detracted from profit maximisation. The main method of demarcation was the implementation of statutory laws. Accordingly, the Savings Bank Law 1921 prohibited commercial banks from operating in the savings bank sector (Kuwayama & Hagan, 2000). Likewise, commercial banking was separated from securities business, and trust business was quite separate from deposit taking under the Loan Trust Law (1952). The loan Trust Law was generally perceived as being contrary to the interests of banks and created a dilemma which was succinctly captured by Vogel (1996, p.170): 'Japanese banks seek to act more like brokers and brokers seek to act more like bankers'.

Article 65 of the Securities and Exchange Law (1948), which was drafted by the American occupation authority after the Second World War, had a particularly restrictive effect on Japanese financial markets. It was introduced to prevent Japanese banks creating powerful conglomerates because organisations such as the 'Zaibatsu', i.e. large family-owned banks and financial cliques were seen to be instrumental in financing Japan's war effort (Morikawa, 1992). Indicative of this type of thinking was the Antimonopoly Law (1947), which also prevented financial institutions from having holdings in excess of 5% in other businesses (Hall, 1993). The Securities and Exchange Law also prohibited banks from both underwriting and dealing in securities with the exception of public bonds, which were closely regulated by administrative guidance. The separation of these functions greatly increased the cost associated with the issuance of debt in Japan and resulted in a significant part of this business being located outside Japan.

The detrimental effect regulation had on the growth of the Japanese economy was exacerbated by the first oil price shock of 1973 (ul-Haq & Howcroft, 2007), which substantially increased the rate of inflation. This led to a marked deterioration in public sector finances and created pressure for reform of the primary government bond market to alleviate the funding burden on the banks as the main underwriters of public bond issues (Hall, 1993). The reaction of the corporate sector to the economic slowdown also had implications for the banking sector. For example, it reduced investment and this had a knock-on effect for the banks by reducing corporate borrowing. The corporate sector was also looking to consolidate their debts and reduce funding costs. Accordingly, they placed pressure on the authorities to provide them with greater access to domestic and international financial markets. Similarly, there was increased pressure to liberalise interest rates and generate real rates of return in the face of high levels of inflation (Vogel, 1996).

The banks themselves were eager for the authorities to liberate interest rates and take a more relaxed approach to demarcation so that they could compete more effectively in the market and diversify their activities. Pressure was also brought to bear on the Japanese authorities by foreign governments, particularly the USA, to introduce reciprocity in

terms of market access and the use of the Yen as an international currency. Despite this pressure, it took some 14 years before the Ministry of Finance (1987) published a report setting out the plans for future reform.

The Eurocurrency market and the emergence of London as an international financial centre

During the post-war period there emerged a global trend towards dismantling the pre-war controls on the movement of international capital (Roberts, 2001). This liberalisation of capital movements facilitated an unprecedented growth in international trade and one extremely important aspect of this liberalisation was the establishment of the Euromarkets centred in London (Moran, 1991). The primary reason as to why London emerged as the principal centre in the Euromarkets was due to a number of reasons. In the first instance a series of deregulatory changes, which occurred over a 20-odd year period eventually liberalised the financial markets in the UK. Arguably commencing in 1969 with the decision to disclose commercial bank profits, a period of systematic deregulation subsequently commenced. These deregulatory changes included inter alia: Competition and Credit Control (1971), a directive from the Bank of England (1984), which outlined how the banking system was to be controlled. As such, it effectively signalled the demise of the commercial bank's cartel on interest rates and, thereby, created an environment in which market forces determined competition within the banking sector.

In 1976 the passing of the Trustee Savings Bank Act and the Post Office (bank services) Act were the first steps in a series of measures designed to transform two public sector savings banks into highly competitive commercial banks operating in the private sector. This coincided with the elimination of official bias against bank lending and the abolition of higher purchase controls, thereby creating both the opportunity and the incentive for banks to compete aggressively in the consumer credit market. Subsequently, the so-called CORSET was abolished in 1980. This was a supplementary deposit levied by the authorities whenever certain liabilities increased above a pre-specified level. Accordingly, it made balance sheet growth beyond a certain level less profitable. The net effect of abolishing the CORSET was to provide banks with both the opportunity and the incentive to compete more effectively in the provision of loans, especially, in the house finance market (Howcroft, 1989). In 1986 radical changes to the London Stock Exchange were introduced. Known as the 'Big bang', these changes, amongst other things, enabled commercial banks to increase their investment banking activities. As such, it eroded the traditional demarcation lines between commercial and investment banking and heralded the emergence of so-called 'universal banks' (Hall, 1987). Finally, the last significant deregulatory change also occurred in 1986 with the passing of the Financial Services Act and the Building Societies Act. Inter alia, the former act introduced new supervisory arrangements based on self regulation with statutory backing and the latter allowed building societies, as mutual institutions, to convert into public limited companies.

The liberalisation and ensuing increased competitiveness of Britain's financial markets coincided with the emergence and growth of the Eurocurrency markets with London as the principal centre. The main currency was US dollars but the term 'Eurocurrency' refers to the deposit and loan of any convertible foreign currency by overseas residents, which attracts an international rate of interest. The most distinguishing feature of the Eurocurrency markets, however, is that they are not subject to the same institutional controls and regulations associated with domestic operations. In this respect, therefore, they have many of the attributes associated with 'offshore' centres (Kern, 1980).

The origins of the Euromarkets are usually traced back to the gradual emergence of a market for US dollars in Europe during the 1950s (Heffernan, 1996; Lewis & Davis, 1987; Roberts, 2001). To a large extent this was because the US dollar eventually emerged as the World's international reserve currency in the post-war period (Little, 1975; Makin, 1972). Consequently, the external demand for dollars by international investors, financial institutions and governments was extremely high. The US government tried to counteract this demand and reduce the pressure on its balance of payments by implementing a restrictive monetary policy. This included a withholding tax, introduced in 1963, on interest and dividends remitted abroad to overseas residents (the Interest Equalization Tax). Regulation Q was introduced in 1965 and imposed a ceiling on interest rates paid on deposits held in the USA. During that year, Voluntary credit Restraints was also introduced and effectively restricted the international lending activities of domestic banks (Duffey & Giddy, 1978; Einzig, 1970). The primary objective was to reduce the outflow of dollars from the USA but the net effect of these measures was to increase the propensity of foreign investors to deposit US dollars overseas. Moreover, US banks circumvented these restrictive measures by establishing overseas subsidiaries in Europe. Given its established, strong and innovative financial services sector, London provided an ideal market for this business (Machlup, 1970; Niehans & Hewson, 1976).

These restrictions on the free flow of capital provided the initial major incentives for the emergence of the Eurocurrency market. However, when the USA removed these restrictions in 1974 the market was already established and the market continued to grow at an unprecedented rate. The main impetus for this second phase of growth came from the unprecedented oil price increases in 1974 and 1979 and the subsequent recycling of surplus funds by private banks to developing countries (ul-Haq & Howcroft, 2007). In essence, oil exporters received a massive increase in dollar-denominated funds from the export of oil and most of these funds were placed in bank deposits in the London Eurocurrency market. Increases in the price of oil created significant balance of payments deficits in industrialised and developing countries, which were exacerbated by World recession. Accordingly, the bank's traditional domestic markets went into decline just at the very time when new markets, in the form of international loans to finance balance of payments deficits in developing countries, were presenting themselves. As such, it marked the beginning of wholesale banking on a truly global or international scale.

The emergence of the Eurocurrency market also coincided with post-war economic policies aimed at free trade and the abolition of trade barriers. Consequently, at the very time when large corporations were beginning to expand their activities and become multinational, the banks were in a position to provide a truly global service. The combined effect of these changes had a significant market pull effect on banks from Japan and provided the opportunity for them to achieve their growth and profit objectives. As the Bank of England (1973, p. 185) noted at the time: 'The expansion of international business has been accompanied by the development of world-wide banking networks, on a more sophisticated level than hitherto, to meet the needs of the biggest international companies'.

Rugman and Verbeke's consistency of home and host government goals model

The literature makes a distinction between two traditional models for explaining how MNEs organise and manage international operations, i.e. ethnocentric and polycentric models (Perlmutter, 1969). In essence, these models represent centralised and decentralised approaches, and the basic differences revolve around the primary organising principles and managements systems for establishing international operations (Bartlett &

Goshal, 1989; Hedlund, 1986; Prahalad & Doz, 1987; White & Poynter, 1990). Rugman and Verbeke's (1998) Consistency of Home and Host Government model has elements of both the ethnocentric and the polycentric approach and, therefore, provides a good basis to articulate the main arguments of the paper. In essence the model assumes that all matters are resolvable and, consequently, they consider the 'micro' aspects of the firm and place emphasis on the ability of managers to determine corporate actions. However, their theory does not fully take into account the effect that the external environment has on a firm's decision to internationalise. Instead, internationalisation is regarded as a choice that firms make based upon the decisions, abilities and experience of managers. *Ceteris paribus*, it follows that the more international experience managers have the greater the propensity for firms to internationalise (Sapienza et al., 2006).

Rugman and Verbeke's (1998) recognises the fact that firms can be in 'conflict' with the external environment. In common with Caves (1982) and other neoclassical economists this means that firms are not maximising profits. Similarly, the model assumes that firms, which successfully internationalise have a complementary or strong home base and, therefore, any potential conflict situation relates to the host country. Moreover, Rugman and Verbeke also posit that international firms have centralised and hierarchical organisational structures that facilitate the development of FSAs in the home country (Bartlett & Goshal, 1989). Accordingly, a further assumption is that when firms internationalise they effectively replicate home country production processes and managerial structures/styles in the host country.

Implicit in Rugman and Verbeke's theory, therefore, is a resource-based view of the firm, which is regarded as being conducive to the development of FSAs that are capable of overcoming any conflict with the home country (Barney, 1991; Barney, Wright, & Ketchen, 2001; Penrose, 1959). Internationalisation is, accordingly, achieved through successfully transforming the firm from an ethnocentric to a polycentric organisation where FSAs are specific to the host country (Malnight, 1996). However, Child and Yan's (2003) study of international joint ventures between Chinese and British companies has revealed that it is the ability of firms to learn and develop new FSAs outside the home country that resolves conflicts and facilitates internationalisation.

To explain the dynamics of this firm-government interaction Rugman and Verbeke (1998) developed the framework shown in Figure 1. This framework is useful in explaining the situation where an MNE has to respond to a new environment in the host country. Accordingly, quadrant 1 depicts the Hymer (1976) quasi-Marxist Sovereignty at Bay view of a conflict of goals between the MNE and the governments in both the home and host countries. The focus is on distributional issues and the power of the MNE versus the host nation (Dunning & Rugman, 1985). As a prerequisite for internationalisation, this situation will require the MNE to establish FSAs that complement those of the home country government and then transform them into new FSAs in the host country (Child & Yan, 2003). As stated above, this process of internationalisation, therefore, involves the transformation of an organisation from an ethnocentric firm into a polycentric or geocentric firm (Perlmutter, 1969).

The fourth quadrant is the polar position of quadrant 1 and is more consistent with Vernon (1966). Accordingly, it reveals a situation in which the goals of government and the MNE in both the home and host countries are complementary. It follows, therefore, that this is the ideal situation because it corresponds to Caves' (1982) view of a centralised and hierarchical MNE, which facilitates an ethnocentric approach to internationalisation. Rugman and Verbeke (1998, p.124,) accordingly argue that: 'Internationalisation grows via a product life cycle of technology in which intensive

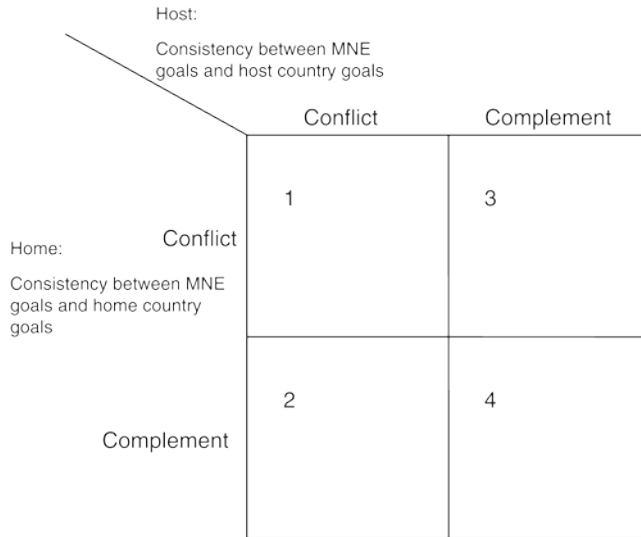


Figure 1. The consistency between MNE and Home and Host Government Goals. Source: Rugman and Verbeke (1998).

FSA's developed initially in a strong home base, are produced by wholly owned subsidiaries in host countries'.

Quadrant 3 depicts the more complex situation of a conflict of goals between the home government and the MNE but in contrast to quadrant 1, the MNE's goals complement those of the host countries' government. There has been less research on this situation but it generally refutes the political science-led rationale for this quadrant (Eden, 1985). Accordingly, there is little or no evidence to suggest that the rationale for this quadrant is based on systematic transfer pricing other than as a response to effective tax rate differentials and other exogenous market imperfections. Rugman and Verbeke (1998), therefore, once again follow the view of Caves (1982) and argue that this situation is not readily conducive to internationalisation because the MNE does not have a strong home base to overcome conflicts. Moreover, they state that (p. 126): 'It would be incorrect to assume that MNEs, faced with excessive goal conflicts in their home countries, seek co-operation with . . . host nations, where goal complementarity is prevailing'.

In contrast, quadrant 2 depicts an equally complicated situation where the home government and the MNE's goals are complementary but there is a conflict between the goals of the MNE and the host government. As such, it is broadly representative of Porter (1990) and the larger literature on strategic trade policy (Tyson, 1993; Yoffie, 1993). In this situation, the MNE is in a good position to internationalise by re-creating home country FSA's in the host country and becoming a polycentric or geocentric organisation. However, Rugman and Verbeke (1998) qualify this oversimplified view by claiming that governments do not have the necessary knowledge and internal infrastructures to facilitate the internationalisation of domestic firms.

Regulatory push and market pull

As mentioned earlier, Rugman and Verbeke's (1998) framework is built on the assumptions that firms have a strong home base and that all conflicts are resolvable. However,

this assumption might not hold in all situations. For example, in quadrant 3, which depicts conflict in the home country but complementary goal alignment in the host country, there is a distinct possibility that the conflict with the home government might be irresolvable. This situation could occur with banks and other financial institutions, which form a unique and integral part of the economy. Accordingly, governments might apply restrictions on the activities of banks, in order to control inflation and implement monetary policy. As a direct consequence, banks might internationalise and move into more liberal financial markets in order to increase profitability. Under these circumstances a combination of regulatory push, i.e. a situation where regulation or a change in regulation constrains the operations of a firm, and market pull, i.e. a situation where a firm is drawn to a market because of the opportunity to increase profitability, might induce a bank to internationalise before conflicts with the home country are resolved. However, this does not necessarily preclude a firm from having introduced innovations to adapt better to the external environment and thereby create FSAs that are conducive to reducing conflicts in the home country prior to internationalisation. Accordingly, management will have learned from their experiences in the home country and might introduce these new FSAs in the host country as part of operational learning (Child & Yan, 2003).

Figure 2 encapsulates the situation described above by revealing the potential responses of a firm to its external environment. In accordance with Rugman and Verbeke's (1998) theory, the bottom left corner depicts a situation where a firm can operate unhindered by regulation and there is little or no incentive to internationalise. The opposite situation and one which is more difficult to reconcile to Rugman and Verbeke's theory is revealed by the top right-hand corner. Accordingly, this paper contends that when regulatory push and market pull are present, it can be regarded as perfectly rational for firms, such as banks, to seek more profitable opportunities in host countries (Weiss, 2005).

The basis for this contention stems from the fact that it is the primary responsibility of management to create wealth and maximise profitability (Friedman, 2007). In this respect, free or liberalised markets allow managers to maximise profitability without political interference or restriction. Moreover, such a response is entirely compatible with

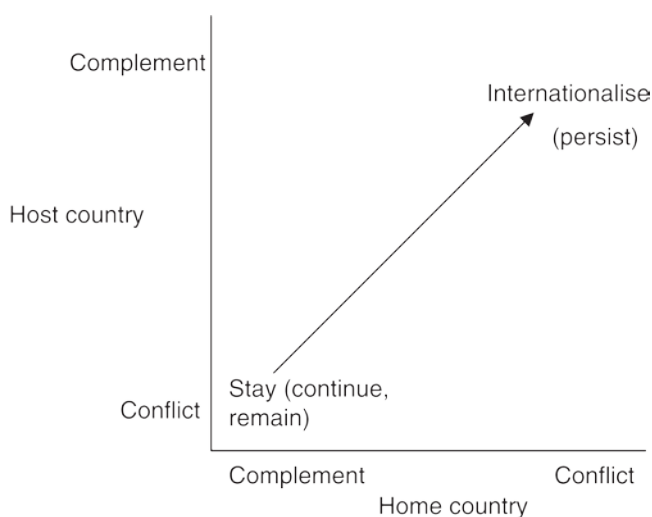


Figure 2. Internationalisation as a response to changes in regulation.
Source: Authors.

Rugman and Verbeke's (1998) behavioural model, which takes an efficiency view of the firm and accordingly implies that organisations should always maximise profits. Similarly, Bauer (1994) argues that global diversification allows a firm to stabilise and increase its profits by broadening its markets and spreading risk. In this respect, the model of regulatory push and market pull allows a firm to pursue its primary goal of profit maximisation and, thereby, meet the key internationalising elements identified by Sapienza et al. (2006) of achieving growth and survival.

The model of regulatory push and market pull does not, however, conform to Caves' (1982) Process Theory, which states that firms internationalise and move into countries with a close 'psychic distance'. This non-conformity with Process Theory is clearly evidenced by the internationalisation of Japanese banks and their entry into the UK in the 1980s. The deregulated financial services markets in the UK were the exact polar of Japan's highly regulated markets and, therefore, there was a substantial psychic distance between the two countries. Moreover, this was arguably the single most important consideration in the decision of Japanese banks to internationalise because it provided them with the opportunity to compete in a free market and increase profits. In addition to the different approaches to regulation, the psychic distance between Japan and the UK was also compounded by their totally different cultural, political and economic regimes (Westney, 2006).

Conclusion

The paper has argued that the twin forces of regulatory push and market pull were largely responsible for the internationalisation of Japanese banks into London. Japan's highly regulated financial services markets were in stark contrast to London and the Eurocurrency markets liberal regimes (Tsutsui, 1999). The controls on interest rates (Düser, 1990), the demarcation of the financial service markets (Vogel, 1996) and the regulations placed on the Yen as an international currency (Düser, 1990) constrained the Japanese banking industry and created regulatory push in the form of a desire to pursue more profitable international opportunities. Japan's regulatory regime combined with protectionist policies, which effectively precluded foreign bank entry, nevertheless, allowed the Japanese banks to develop FSAs in the home market. In this respect the paper is in total agreement with view of Caves (1982) and Rugman and Verbeke (1998). However, in contrast to these authors the paper has argued that this created regulatory push and led to the internationalisation of Japanese banks.

Simultaneously and in direct contrast to the situation in Japan, deregulation in the UK, which inter alia included Competition and Credit Control (Bank of England, 1984), the abolition of the CORSET, the passing of the Financial Services Act (Howcroft, 1989) and the so-called 'Big Bang' (Hall, 1987), created a liberalised financial services sector. These deregulatory developments coincided with the emergence and unprecedented growth of the Eurocurrency market with its principal centre in London. Moreover, its emergence as an international market was so dramatic that the central authorities had no real time to consider how to control it and, therefore, it was essentially unregulated (Kern, 1980). Accordingly, the emergence of liberalised financial services markets in the UK combined with the spectacular growth of the Eurocurrency markets centred in London created market pull and attracted Japanese banks in search of growth and increased profitability.

The Eurocurrency markets were the principal means for recycling petro-dollars and financing the balance of payments deficits created by the increase in the price of oil during the 1970s. However, when the problems with debt repayment started to emerge in the late 1970s, it became clear that the Latin American debt crisis was imminent (United Nations, 1991). In this respect, some authors have found that financial and

economic crises can present foreign banks with growth opportunities (see e.g. Detragiache & Gupta, 2006; Peek & Rosengren, 2000). It was, therefore, perhaps no coincidence that the internationalisation of Japanese banks was most marked in the 1980s.

Somewhat significantly, the Japanese banks had not been drawn into the Latin American debt crisis and to some extent this was because of the regulations and controls imposed by their home government. High levels of regulation, therefore, provided the Japanese banks with a relatively strong base and allowed them to develop FSAs, especially, hierarchical management structures and a reputation for disciplined management, which facilitated the internationalisation process. In this respect, the paper concurs with the findings of Dunning (1997), Kolte (2006), and Cheney (2006), etc, who have found that high levels of regulation can increase efficiency and lead to internationalisation. The paper, however, does not fit well with Caves' (1982) Process Theory because internationalisation occurred despite significant 'psychic distance' between Japan and London. Similarly, in contrast to Rugman and Verbeke (1998) the FSAs developed by Japanese banks were not sufficient to overcome conflict with the home government. Moreover, although there was a conflict with the home country government this did not result in Japanese banks leaving Japan. Instead the internationalisation process was undertaken while simultaneously remaining in the home country and working to reduce governmental conflict (Ministry of Finance, 1987).

The liberalised regime in London and the timing of their internationalisation also allowed the Japanese banks to establish themselves as investment bankers rather than commercial banks. This was because the Latin American debt crisis heralded the decline of traditional deposit and lending activities associated with commercial banks and an increase in the sort of capital and securities activities associated with investment banking. Accordingly, the Japanese banks became major players in the various securities markets in London. This final consideration raises two further points: although regulatory push and market pull were undoubtedly important determinants of Japanese banks internationalisation, the uniqueness of the timing was also an important consideration. Moreover, although the Japanese did replicate some home country FSAs in London, especially those relating to management style and structures, they also had to develop new FSAs in order to compete as investment banks (Child & Yan, 2003).

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