Introduction
The Making of Financial Regulation and Deregulation: A Long View

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The global financial crisis triggered in 2007–08 by the collapse of the US subprime mortgage market has dramatically revived the discussion on financial regulation in industrialized economies. Generalized regulatory failure and forbearance have been blamed by Dominique Strauss-Kahn, Managing Director of the IMF, as a major factor of the excess risk taken up by banks.[1] Confidence in market-based self-regulation has been shaken as internal systems of risk control failed to prevent the accumulation of enormous losses in international banks of the highest reputation. As Lawrence Summers, a former Secretary of Treasury under the Clinton Administration, has admitted, 'it should be recognized that to a substantial extent self-regulation is deregulation. Allowing institutions to determine capital levels based on risk models of their own design is tantamount to letting them set their own capital levels. We have seen institutions hurt again and again by events to which their models implied probabilities of less than one in a million'.[2] The effectiveness of prudential regulation to discipline bank managers has been severely questioned, namely on grounds of their motivation. 'Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief,' former chairman of the FED, Alan Greenspan, told a Congressional hearing.[3]

The limits of financial supervision have been revealed by the SEC's failure to detect giant pyramidal frauds like Bernard Madoff's in time. Yet only few months earlier, the Bush Administration's Treasury Secretary and former chairman of Goldman Sachs, Henry Paulson, blamed the Sarbanes-Oxley Act, enacted after the wave of corporate and accounting scandals of 2001, for 'excessive regulation', calling for a lighter regulatory touch.[4] But many of those who, back in the long boom of the 1990s, staunchly opposed tougher regulation on derivatives have now confessed that the business of spreading risk through financial engineering has got out of control. The extraordinary characteristics of the present crisis have required extraordinary interventions by the authorities. In the USA, the Federal

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1 *Financial Times*, 25 September 2008.

2 *Financial Times*, 1 June 2008.

3 *New York Times*, 23 October 2008.

4 *New York Times*, 27 July 2008.

Reserve's safety net has for the first time been extended to investment banks. Both in the USA and in Europe, governments have rushed to arrange emergency plans with massive injections of taxpayer money to recapitalize ailing institutions and preserve the public's confidence in the banking system. Whatever its gravity and duration, the crisis has put into a radically new perspective the long wave of financial deregulation that started in industrial and emerging economies at the end of the 1970s. There can be no doubt that the regulatory regime of financial services on both shores of the Atlantic will emerge profoundly reshaped by the global crisis.

How did we get here? What factors have driven the ebb and flow of financial regulation over the last two centuries? What lessons can we draw from the past regarding the impact of financial crises on the regulatory attitude of governments? And what has history to say about the making of financial regulation and deregulation?

Two theoretical approaches compete to explain the historic cycles of financial regulation, one based on a public-interest motivation and another one emphasizing the role of private interests. In the public-interest view, governments are conceived of as benevolent social planners which intervene to regulate and oversee financial systems when informal rules of practice and self-regulation (i.e. market rules collectively administered by market actors) prove incapable of preventing market inefficiencies. The special features of banking intermediation make financial institutions particularly vulnerable to crises. They act as delegated monitors of borrowers on behalf of depositors and confront problems of adverse selection (*ex ante* screening) and moral hazard (*ex post* monitoring). The bank-depositor relationship also entails a moral hazard problem, as banks have incentives to increase leverage (thus operating on low capital-deposit ratios) in order to increase returns on equity. Leverage, 'transformation' (turning liquid deposits into illiquid assets) and asset opaqueness expose them to runs and panics with potentially systemic externalities.[5] Therefore, policymakers are called upon to intervene in order to ensure the safety and soundness of the management of risky assets by the banking system, and to prevent contagion effects that may disrupt the working of the payment and credit systems, thus leading to systemic crises and social welfare losses.

This economic rationale underlies the concept of banking as a matter of public interest and has justified traditional means of prudential regulation, such as capital requirements to create a buffer against losses, as well as to act as a disciplinary device for banks' risk-taking. Motivations of this sort are also advanced for structural regulations such as controls on bank chartering and restrictions on entry aimed at preventing disruptive competition. By increasing the franchise value of licensed or incumbent intermediaries, these are assumed to limit bankers' incentives to take

[5] D.W. Diamond, 'Financial Intermediation and Delegated Monitoring', *Review of Economic Studies*, 51 (1984), pp. 393–414; D.W. Diamond and P.H. Dybvig, 'Bank Runs, Deposit Insurance and Liquidity', *Journal of Political Economy*, 91, 3 (1983), pp. 401–19.

risks and encourage a cautious conduct of business.[6] Likewise, the introduction of deposit insurance serves to promote financial stability, by protecting uninformed depositors and preventing panics. However, deposit insurance carries high costs in terms of weakened market discipline, given that depositors and debt-holders have less incentive to monitor banks, up to the point where they become indifferent between solvent and insolvent institutions. In addition, they magnify moral hazard since managers may increase leverage and asset risk to maximize shareholder value, thus in fact maximizing the value of the insured subsidy.[7] A deposit insurance scheme therefore requires a prudential regulation of banks' risk-taking complemented by some supervision of the banking system by public authorities (mainly but not exclusively performed by central banks) in the form of regular disclosure of balance sheets and on-site inspections.

In the same vein, imperfections and failures in markets for financial assets provide an economic rationale for regulating capital markets. Risk-taking by individual firms can generate negative externalities for other firms and individuals that are not their counterparties. Market discipline is insufficient to deal with the social costs of disrupted financial market activities and the ensuing loss of wealth and output. Likewise, private firms have incentives that limit the amount and the quality of information they provide to the public, as the social benefit of information is greater than the private benefit to those who produce it. This justifies government intervention in its multiple forms – from public licensing of market intermediaries to disclosure requirements and prohibition of insider trading – in order to discipline risk taking, assure transparency and deter frauds, manipulations and other forms of misconduct.[8] Historically, the regulatory and supervisory reforms promoted by the Roosevelt Administration during the Great Depression – from the Glass-Steagall Act of 1933 to the Securities Act and the Securities Exchange Act of 1933–34 – are often regarded as paramount examples of public intervention aiming at limiting the social losses of financial instability.

The competing view of financial regulation to this one has been developed by a recent tradition of theoretical and empirical research based on a political-economy approach. In this approach, financial regulation can be interpreted as the outcome of a policy-making process in which special interests with different objective functions and political influences compete to use the coercive power of the state in order to appropriate rents. This literature considers politics and political institutions as the main drivers of the laws, regulations and controls which affect the financial system. It investigates how the preferences of politicians and interest groups may enhance – or hinder – financial development and influence the financial

[6] M.C. Keeley, 'Deposit Insurance, Risk, and Market Power in Banking', *American Economic Review*, 80, 5 (1990), pp. 1183–2000.

[7] M. Klausner, 'Bank Regulatory Reform and Bank Structure', in M. Klausner, L.J. White (eds), *Structural Change in Banking* (Homewood IL, 1993).

[8] R. Dodd, The Economic Rationale for Financial Market Regulation, Financial Policy Forum, Special Policy Report no. 12, 2002.

decisions of corporations, the working of the banking sector and the operation of financial markets.[9] Legal and political reforms can be modelled as an outcome of the interplay of governments and policymakers with incumbent interests within a set of institutional mechanisms which may range from corruption to lobbying, up to the capture of the policy-making process by economically entrenched groups.

Recent studies explore how political institutions throughout the 19th and 20th centuries managed the conflict of interest which is endemic in the relationship between the state and the financial system. On the one hand, this involves the role of the government in strengthening the rights of private financial claimholders through the enforcement of financial contracts. On the other, it focuses on the capture of financial markets and intermediaries as a source of government revenue.[10] In this perspective, the rise of interstate branching prohibition and entry barriers – a manifestation of an 'abiding fear of bigness'[11] so distinctive of the US banking system – can be explained as a consequence of the large dependence of states' finances on bank chartering and other bank-related revenues, and successful rent-seeking by local bankers.[12] Likewise, the introduction of Federal Deposit Insurance in 1933, far from being an emergency measure principally aimed at protecting small depositors in the turmoil of the Great Depression, represented a political victory of small, unstable unit banks which had vainly advocated federal legislation on banks' liability insurance for half a century.[13]

The political-economy approach also puts the regulation of financial markets in a different perspective. Some contend, for instance, that the 'Blue Sky Laws' enacted by several American states between 1911 and 1933 to regulate the offer and sale of securities to the public were not so much a device to address widespread frauds as rather the result of bankers' political pressure to limit the threat of disintermediation brought home by the development of securities markets. Likewise, some features of the Securities Act of 1933, typically regarded as a 'full disclosure' statute, can be properly understood as a means to protect separate wholesale and retail investment banks from the competition of integrated firms.[14]

Finally, the political-economy approach also pays attention to how limited government and democratization were positively, although not monotonically, related to financial development in the nineteenth century – eroding entry barriers and broadening the access to finance – in both the USA[15] and Europe.[16] From this point of view, the degree of political participation is considered a critical element that influences political decisions over finance. Research suggests that the narrower the social basis of political regimes – such as those under suffrage restrictions or autocracies – the more exclusionary is likely to be the ensuing regulatory regime. Democratic, information-rich and transparent environments may allow the voice of advocates of public interest to be heard, whereas in weak democratic institutions, incumbent interests are better positioned to capture the process of regulation and policy-making.[17] This would explain why autocratic regimes tend to increase regulatory restrictions on financial markets and intermediaries, as well as to establish state control over finance in order to maximize their borrowing powers and constrain the emergence of competing power centres. Monopoly rights, barriers to entry or regulations can thus be used to grant rents to connected elites and incumbent interests in return of political support, thus favouring the emergence of an oligopolistic structure of financial systems. Within autocratic regimes, lobbying and regulation capture can be enhanced by the absence of political rights, the opaqueness of the law-making process and the concentration

9 M. Pagano, P. Volpin, 'The Political Economy of Finance', *Oxford Review of Economic Policy*, 17, 4 (2001), pp. 502–19; S. Haber, R. Perotti, The Political Economy of Financial Systems, Timbergen Institution Discussion Paper, no. 045/2, 2008.

10 H. Bodenhorn, *State Banking in Early America. A New Economic History* (Oxford, 2003) and id., 'Bank Chartering and Political Corruption in Antebellum New York. Free Banking as Reform', in E. Glaeser and C. Goldin (eds), *Corruption and Reform. Lessons from America's Economic History* (Chicago, 2006), pp. 231–57. See also S. Haber, A. Razo and N. Maurer, *The Politics of Property Rights. Political Instability, Credible Commitments, and Economic Growth in Mexico 1876–1929* (Cambridge, 2003), and the papers collected in S. Haber, D.C. North and B. Weingast (eds), *Political Institutions and Financial Development* (Stanford, 2007).

11 J.H. Kareken, 'Federal Bank Regulatory Policy. A Description and Some Observations', *The Journal of Business*, 59, 1 (1986), pp. 3–48, p. 6.

12 The seminal contributions on this issue are E.N. White, 'The Political Economy of Banking Regulation, 1864–1933', *Journal of Economic History*, 42, 1 (1982), pp. 33–40; and id., *The Regulation and Reform of the American Banking System, 1900–1929* (Princeton, 1983). See also N. Economides, R.G. Hubbard and D. Palia, 'The Political Economy of Branch Restrictions and Deposit Insurance', *Journal of Law and Economics*, 29 (1996), pp. 667–704.

13 C.A. Calomiris and E.N. White, 'The Origins of Federal Deposit Insurance', in C. Goldin and G. Libecap (eds), *The Regulated Economy. A Historical Approach to Political Economy* (Chicago, 1994), pp. 145–88.

14 P.G. Mahoney, 'The Origins of the Blue-Sky Laws. A Test of Competing Hypotheses', *Journal of Law and Economics*, 46, 1 (2003), pp. 229–51; and idem, 'The Political Economy of the Securities Act of 1933', *Journal of Legal Studies*, 30, 1 (2001), pp. 1–31.

15 J. Wallis, R. Sylla and J. Legler, 'The Interaction of Taxation and Regulation in 19th Century US Banking', in C. Goldin and G. Libecap (eds), *The Regulated Economy. A Historical Approach to Political Economy* (Chicago, 1994), pp. 122–44; E. Benmelech and T. Moskowitz, The Political Economy of Financial Regulation. Evidence from US State Usury Laws in the 18th and 19th centuries, NBER Working Paper no. 12851, 2007.

16 K. Ng, 'Free Banking Laws and Barriers to Entry in Banking, 1838–1860', *Journal of Economic History*, 48, 4 (1998), pp. 877–89; J.L. Brosz and R.S. Grossman, 'Paying for Privilege. The Political Eeonomy of Bank of England Charters, 1694–1844', *Explorations in Economic History*, 41, 1 (2004), pp. 48–72; N. Lamoreaux and J.-L. Rosenthal, Corporate Governance and the Plight of Minority Shareholders in the US before the Great Depression, NBER Working Paper no. 10900, 2004.

17 E.H. Feijen and E. Perotti, The Politieal Eeonomy of Financial Fragility, CEPR Discussion Papers no. 5317, 2005.

of political powers, as recent studies of financial regulation in Tsarist Russia, Porfirian Mexico and Franco's Spain seem to suggest.[18]

Some of the essays collected in this volume suggest that the two approaches should not be considered as mutually exclusive. Indeed, financial regulation can, over the long run, be thought of as a dynamic process driven by a continuous tension between public and private interests. Historically, financial and banking crises were often interpreted as signals of market failures and provided critical focal points for public debates and policy makers' interventions. However, the outcome in terms of legislation and regulation was shaped by historically-determined and country-specific institutions (the legal framework, the nature of the state, the articulation of the political system) within which the interplay of private interests took place.

In the first chapter, Phil Cottrell (*'Conservative abroad, liberal at home': British Banking Regulation during the Nineteenth Century*) analyses the interaction of different constituencies in the evolving regulation of banks in the first half of the nineteenth century in response to recurrent commercial crises. In a system dominated by private banking houses, the rise of joint-stock banks, permitted after 1826, was perceived by many as a risky innovation since, as in Samuel Gurney's words, 'business was best conducted personally by those whose entire fortunes were at risk'. The preservation of unlimited liability, the introduction of minimum capital requirements and the existence of large controlling shareholders answerable to depositors were debated as regulatory instruments to safeguard the holders of banks' liabilities against possible abuses. At the same time, restrictions on the geographical expansion of joint-stock banks were discussed to preserve the Bank of England's privileges in the London metropolitan area and to limit competition between old and new banks. Cottrell describes how the political clash between incumbents and new entrants led in 1833 to the rejection by the House of Commons of the compromise proposed by Chancellor of the Exchequer Althorp for chartered note-issuing joint-stock banks. The chapter also describes how regulations and restrictions designed for chartered colonial banks helped set a new regulatory framework for domestic banks in the aftermath of the joint-stock banking 'mania' of the late 1830s. This led to the so-called 'onerous regulation' included in the Joint Stock Banking Act of 1844 in spite of the active and critical involvement of the banking community in the design of the new legislation.

The influence of private interests in determining cross-country differences in bankruptcy procedures is the subject of Paolo Di Martino's contribution in

[18] B. Anan'ich, 'State Power and Finance in Russia, 1802–1917', in R. Sylla et al. (eds), *The State, the Financial System and Economic Modernization* (Cambridge, 1999), pp. 210–23; N. Maurer and A. Gomberg, 'When the State is Untrustworthy. Public Finance and Private Banking in Porfirian Mexico', *Journal of Economic History*, 64, 4 (2004), pp. 1087–1107; N. Maurer and S. Haber, 'Related Lending and Economic Performance. Evidence from Mexico', *Journal of Economic History*, 67, 3 (2007), pp. 551–81; S.A. Perez, *Banking on Privilege. The Politics of Spanish Financial Reform* (Ithaca, 1997).

chapter 2 (*Lobbying, Institutional Inertia, and the Efficiency Issue in State Regulation: Evidence from the Evolution of Bankruptcy Laws and Procedures in Italy, England, and the US (c.1870–1939)*). Historically, bankruptcy laws have had to find a difficult balance. On the one hand, they are concerned with the protection of creditors' rights, which guarantees ex ante the availability of cheaper and more abundant credit to firms, but can generate *ex post* inefficiencies and social costs due to frequent firm liquidations. On the other, strong protection of debtors may enhance ex ante moral hazard but generates ex post efficiency gains by preventing or reducing debt overhang, unnecessary liquidation of collateral and negative externalities to third parties (such as customers and employees). Di Martino argues that in the interwar period experts both in the United States and Italy perceived the British regulation of bankruptcy as 'optimal', thanks to soundly regulated debt discharge, efficient use of friendly settlement and the public nature of procedures. In both countries, however, bankruptcy laws deviated substantially from the British pattern as a consequence of considerations of political economy. In the USA the political influence of the pro-debtor lobby led to a Bankruptcy Law which gave more emphasis to debt discharge than to protecting creditors' rights. In turn, in Italy the strong pro-creditor legal tradition of the Napoleonic code proved critical in shaping the attitude of lawyers and lawmakers, thus failing to enact efficient alternatives to firm liquidation.

In chapter 3, Eugene White (*Regulation and Governance: A Secular Perspective on the Development of the American Financial System*) suggests that major turning points in the history of US financial regulation can be better explained as adjustments to productivity shocks in the real economy than as responses to crises. Technological changes related to the 'New Economy' of the 1920s challenged the existing institutions and financial techniques. These were based on a 'pyramided structure of reserves and correspondent balances link[ing] thousands of small banks with incompletely diversified loan portfolios [that] left the financial system particularly subject to shocks'. Uncertainty about the expected return on capital-intensive investment carried out by vertically-integrated big business magnified information asymmetries in the financial sector, making it harder for traditional banks to screen and monitor borrowers. The rise of specialized investment banks, such as JP Morgan, and rating agencies provided market information that mitigated the problem of monitoring by investors. At the same time, existing regulation constrained the ability of commercial banks to cope with the ongoing transformations. This led them to develop separate security affiliates to overcome geographic restrictions and carry out their investment banking business, with the result that they evolved towards a universal-banking pattern. In the turmoil of the Great Depression, these universal banks were blamed for abuses and manipulations – an accusation vindicated by recent research. Indeed the market considered universal banks more trustworthy than independent investment banks, and much

of the criticism raised during Congressional hearings proved ill founded.[19] The Glass-Steagall Act was less a response to market failure than a victory of the powerful lobby of investment bankers. Likewise, the 'loosely organized cartel with barriers to entry and price controls' that resulted from the Banking Acts of 1933–35 protected the rents of small unit banks by preventing the consolidation and geographical diversification of large banks. As White explains, '[the crisis] made it difficult to identify the real problems of the financial system and (...) left the door open to adroit political entrepreneurs with their pet schemes'.

Since the interwar period and until the 1970s, financial regulation in industrialized economies has gone far beyond traditional prudential rules. With few exceptions (West Germany most notably), European governments extensively made use of policy instruments such as compulsory and non-remunerated reserve requirements, cash and liquidity ratios, interest-rate controls, credit ceilings and directives on credit allocation. Such regulations were implemented either by suasion, as in the case of the UK,[20] or more often by command-and-control administrative instructions. In some cases, such as Italy and France, this escalation was reinforced by government ownership of major banks, which gave the State an unprecedented pervasive role in intermediating and allocating capital. Domestic regulation was often complemented by external controls on foreign exchange and capital markets embedded in the regulatory design of the Bretton Woods system. They became a permanent feature of many European financial systems, with West Germany providing the only counter-example of precocious liberalization – although briefly reversed in the early 1970s.[21]

Usually, the bulk of the regulatory framework (both domestic and external) was inherited from the interwar period. New constraints were, however, introduced in the 1960s and 1970s as a way to enhance monetary management. Central banks in this period in Europe diverged as to targeting options (money, domestic credit, exchange rate) and often chose combined approaches.[22] In any case, reserve requirements, qualitative and quantitative controls, and indirect controls were

[19] E.N. White, 'Before the Glass-Steagall Act. An Analysis of the Investment Banking Activities of National Banks', *Explorations in Economic History*, 23, 1 (1986), pp. 33–55; R.S. Kroszner and R.G. Rajan, 'Is the Glass-Steagall Act Justified? A Study of the US Experience with Universal Banking before 1933', *American Economic Review*, 84, 4 (1994), pp. 810–32.

[20] J.E. Wadsworth (ed.), *The Banks and the Monetary System in the UK 1959–1971* (London, 1973), pp. 99–130.

[21] H.-J. Voth, 'Convertibility, Currency Controls and the Cost of Capital in Western Europe, 1950–1999', *International Journal of Finance and Economics*, 8, 3 (2003), pp. 255–76; C. Wyplosz, 'Exchange Rate Regimes. Some Lessons from Post-war Europe', in G. Caprio et al. (eds), *Financial Liberalization. How Far, How Fast?* (Cambridge, 2001), pp. 125–58.

[22] A.C.F. Houben, *The Evolution of Monetary Policy Strategies in Europe* (Dordreeht, Boston and London, 2000), pp. 141–81.

deployed allegedly in order to enhance the effectiveness of monetary policy in controlling domestic liquidity and bank lending. The process peaked in the 1970s and its intensification led in many countries to a comprehensive regime of financial repression. This was 'a set of policies, laws, regulation, taxes, distortions, qualitative and quantitative restrictions, which do not allow financial intermediaries to operate at their full technological potential'.[23] It was soon acknowledged, however, that such compacts of 'conduct' constraints, while preventing banking systems from operating efficiently, rarely achieved their alleged objective of improving efficiency in monetary management. Another general consequence was the underdevelopment of capital markets and the uncontested dominance of the government as a borrower. Yet, many European governments were generally slow in reforming their banking and financial systems. Why were regimes of financial restriction so pervasive and resilient in Europe?

Political economy interpretations of domestic and external financial constraints emphasize their role as a potential source of revenue for governments. Arguably they provide access to artificially cheap domestic funding from the banking system or capital markets, usually in combination with seigniorage and inflationary finance. This may prove especially appealing to governments with low revenues from income taxes as a consequence of widespread corruption, technical or political constraints on the verification of income across social groups, or large underground economies.[24] Institutional and political characteristics, such as political instability or dependent central banks, may increase the government's incentive to resort systematically to implicit revenues, as a weak incumbent government does not fully internalize the future costs of debt servicing and may deliberately resort to over-borrowing.[25] Empirical evidence for capital controls in a sample of 20 OECD countries between the 1960s and the 1980s has been found to be consistent with an inflation-tax explanation. In addition, capital controls have also shown a close association with higher inflation, higher reliance on seigniorage and lower real interest rates in a different sample of 19 industrialized and 42 developing countries in the period 1966–89.[26]

[23] N. Roubini, X. Sala-i-Martin, 'A Growth Model of Inflation, Tax Evasion and Financial Repression', *Journal of Monetary Economics*, 35, 2 (1995), pp. 275–301.

[24] A. Giovannini and M. De Melo, 'Government Revenues from Financial Repression', *American Economic Review*, 83, 4 (1993), pp. 953–63; J.P. Nicolini, 'Tax Evasion and the Optimal Inflation Tax', *Journal of Development Economics*, 55, 1 (1998), pp. 215–32.

[25] A. Alesina and G. Tabellini, 'External Debt, Capital Flight and Political Risk', *Journal of International Economics*, 27, 3–4 (1989), pp. 199–220.

[26] A. Alesina, V. Grilli and G. M. Milesi-Ferretti, 'The Politieal Economy of Capital Controls', in L. Leiderman and A. Razin (eds), *Capital Mobility. The Impact on Consumption, Investment and Growth* (Cambridge, 1994), pp. 289–321; V. Grilli, G.M. Milesi Ferretti, Economic Effeets and Struetural Determinants of Capital Controls, *IMF Staff Papers*, 42, 1995, pp. 517–51.

Adopting a different approach, Rajan and Zingales offer a comprehensive interpretation of the interwar and postwar reversal of financial markets' development based on an interest group theory.[27] In the increasingly closed economies of the 1930s, incumbents (including dominant banks and industrial firms) opposed the development of capital markets, since the latter tended to erode the value of incumbency and to enhance competition, thus undermining their own dominant positions. Such a reversal was strongest in Civil Law countries since it proved easier there for interest groups to influence the policy-making process and capture the legal system. Indeed, it was overturned only in the late 20th century, when international trade and financial openness rendered it unprofitable for incumbents to keep capital markets underdeveloped. Until then, however, Continental systems exhibited a long-lasting pattern of 'relationship finance' – a facet of a more general 'relationship capitalism' under which governments could satisfy the rapidly increasing demand for social insurance stemming from uninsured masses. An alternative explanation is provided by Perotti and von Thadden, who propose a democratic voting model. This suggests that in Continental countries affected by a huge inflationary shock in the post-WW1 period the impoverished middle class was hit by the devaluation of their long-term nominal assets and called for higher social insurance. This shifted their electoral support towards a corporatist system of financial allocation and ultimately weakened financial markets and increased politicized control over finance. The new societal consensus in favour of corporatist governance and labour protection was further strengthened by the political changes set in motion by the Great Depression.[28]

These interpretations are particularly interesting since they adopt a long-run perspective. The secular dimension of state intervention in the financial systems of Britain and France is explored in chapters 4 and 5 by Ranald Michie and Laure Quennouëlle-Corre with André Straus, respectively. In the aftermath of WW2, the two countries exhibited an apparent convergence towards highly regulated banking systems and financial markets, with nationalized central banks strongly dependent on the government, which implemented binding exchange and capital controls. The underlying political economy of the two financial systems, however, remained substantially different. As Michie (*The London Stock Exchange and the British Government in the Twentieth Century*) argues, over the twentieth century the British Treasury interfered significantly in the operations of the London Stock Exchange (LSE) only in emergency periods, such as the two world wars (in order to fund the escalating national debt) and the abandonment of Gold Standard in 1931. Most binding regulations, such as increased controls on dealers and brokers, the prohibition of forward transactions or the imposition of minimum prices, were intended as extraordinary measures and reflected policy coordination achieved between the Treasury, the Bank of England and the members of the Stock Exchange. In normal periods, on the contrary, public authorities resorted to moral suasion and the LSE remained 'a privately owned financial institution exercising some control over securities and investment on behalf of the government'. This supervisory 'semi-official position' reflected an implicit bargain under which the government recognized the LSE as the only authorized securities market in return for its policing of the market and supporting national policies. The monopolistic rents generated by this agreement were undermined by the abolition of exchange and capital controls in 1979 and quickly disappeared with the full deregulation and internationalization of the market after the 'Big Bang' in 1986.

[27] R. Rajan and L. Zingales, 'The Great Reversals. The Politics of Financial Development in the 20th Century', *Journal of Financial Economics*, 69, 1 (2003), pp. 5–50.

[28] E. Perotti and E.-L. von Thadden, 'The Political Economy of Corporate Control and Labor Rents', *Journal of Political Economy*, 114, 1 (2006), pp. 145–75.

In the case of France, the presence of the state in the financial system was much more pervasive, multifaceted and influential than in most countries. It also went a longer way back. Quennouëlle-Corre and Straus (*The State in the French Financial System during the Twentieth Century: A Specific Case?*) interpret this outcome as a consequence of the nature of the French legal system and some critical economic and political events. On the capital-market side, stockbrokers ('agents de change') were public officials appointed by the Ministry of Finance, with their number established by law, while bankers and merchants were excluded from operating in the Bourse (which favoured the thriving of the unofficial, unregulated 'Coulisse' market). The government also supervised the activity of the market and could deny authorization for listing and issuing foreign securities. The banking system, in turn, was characterized by the early prominence of a number of 'public' channels of financial intermediation, such as saving banks (which received strong political support), postal savings and the 'Caisse de Depots et Consignations', all of which played a critical role in financial deepening. Slow growth and uncertainty in the 1930s paved the way for a dramatic increase in the direct financing of the government by the banking system. This shift was officially sanctioned by the heavy 'dirigiste' regulation enacted under the Vichy regime in 1941, which separated commercial from investment banking, introduced a regime of official authorization for bank entry and branching, and brought all public financial intermediaries and cooperative banks under the supervision of the Ministry of Finance. A peculiarly French institution, the 'Circuit du Tresor', aimed at channelling credit from the banking system towards the Treasury, also emerged then. This structure served very well the purposes of postwar 'indicative' planning, and was perfected thanks to the postwar nationalization and later cartelization of the largest deposit banks. The administered financial system, characterized by the pervasive regulation of interest rates, ensured the allocation of bank credit to 'priority' sectors and gave the government, state-owned institutions and local authorities priority in tapping domestic capital markets.

Ever since the nineteenth century, the issue of prudent regulation and financial stability has been intimately related to the pursuit of monetary stability and the emergence of central banking. In Britain, the Joint-Stock Banking Act of 1844 can be considered a parallel outcome of the debate that led in the same year to the Bank Charter Act, which gave the Bank of England a monopoly on note issue.

In the USA, the National Banking Acts of 1863–64 combined the introduction of binding rules for bank chartering under a unified federal regulatory authority (the Comptroller of the Currency) with the introduction of a national currency. Bagehot's rule, according to which central banks should lend freely and quickly at a penalty rate to illiquid but solvent banks, gradually became conventional wisdom in central banking[29] – although the rule too often proves hard to follow in practice, and many criticize its moral hazard effects, especially when emergency liquidity is provided systematically and unconditionally.[30] The Bank of England's credible pre-commitment is often quoted as a key determinant of the absence of major financial crises in Britain after the 1860s, although some argue that the Lender of last Resort function (LOLR) made its headway in British official policy only after WW1.[31] The reluctant and insufficient provision of last-resort credit by the Federal Reserve on the outset of the Great Depression is generally blamed for the wave of nationwide banking panics that shook the US economy in the early 1930s.[32] The evolution of central banks, from special commercial institutions with private shareholders and special privileges, to government banks, pooling gold reserves and providing rediscounting facilities, was lengthy and far from seamless.[33] In chapter 6, Richard Grossman (*The Emergence of Central Banks and Banking Supervision in Comparative Perspective*) reminds us that, in the nineteenth century, the key motivations behind the establishment of national banks (later to become central banks) certainly did not include any LOLR function. Nor was the latter performed necessarily by central banks, as the history of the USA before 1913, Canada and other countries demonstrates.[34] The emergence of LOLR activities between the late nineteenth century and the outbreak of WW1 raised interesting moral-hazard problems and had a significant impact on public confidence in gold-based monetary regimes.[35] It also provided a new economic rationale for the introduction

[29] G. Caprio and P. Honohan, Banking Crises, Institute for International Integration Studies Trinity College Dublin, Discussion Paper no. 242, 2008.

[30] An exeellent introduction to this subject is X. Freixas, C. Giannini, G. Hoggarth and F. Soussa, 'Lender of Last Resort. A Review of the Literature', in C. Goodhart and G. Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort. A Reader* (Oxford, 2002), pp. 39–44.

[31] J.H. Wood, 'Bagehot's Lender of Last Resort. A Hollow Hallowed Tradition', *The Independent Review*, 7, 3 (2003), pp. 343–51.

[32] M. Friedman and A. Sehwartz, *A Monetary History of the United States 1867–1960* (Princeton, 1963), pp. 301–59.

[33] C. Goodhart, F. Capie and N. Schnadt, 'The Development of Central Banking', in F. Capie et al., *The Future of Central Banking. The Tercentenary Symposium of the Bank of England* (Cambridge, 1994), pp. 1–91.

[34] M. Bordo, 'The Lender of Last Resort. Alternative Views and Historical Experience', in C. Goodhart and G. Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort. A Reader* (Oxford, 2002), pp. 108–25.

[35] B. Eichengreen, *Globalizing Capital* (Princeton, 1996), pp. 35–8.

of some form of public supervision on banks with access to central bank's high-powered money. In a similar vein, the central position held by central banks in the financial system and their network of correspondent balances with commercial banks made them the natural candidates to perform this new function. This pattern was not generalized, however (the Nordic countries, Switzerland and other small European countries followed a different path), and gained momentum only after WW1. But, as Grossman shows, to establish when exactly central banks assumed supervisory responsibilities or when informal supervision turned into formal powers proves as elusive and controversial as to determine when their transition to modern central banking was completed. His empirical evidence also suggests that younger central banks created around the turn of the century were more likely to be invested with supervisory duties than their older counterparts, possibly because their organizational structure, ownership and management were more flexible and better able to adjust to new public tasks.

by-product of the public duties gradually assumed by central banks in the early twentieth century was their role as monitors of the national economy, providers of statistical information and advisers of economic policy-makers. In chapter 7, Pablo Martín Aceña and Teresa Tortella (*Regulation and Supervision: The Rise of Central Banks' Research Departments*) provide a timeline of the establishment of in-house Research Departments at European central banks and trace a parallel history of two of them in the interwar years, the 'Servizio studi econonomici e statistici', at the Bank of Italy, and the 'Servicio de Estudios', at the Bank of Spain.

The last quarter of the twentieth century has witnessed a major shift away from the long-established pattern of restricted financial systems towards financial globalization. By the early 1980s liberalization of capital flows and deregulation had risen to the top of the agenda of policy-makers in all industrialized countries. Explaining why this happened is not straightforward from a political-economy perspective. A popular idea among economists points to the impact of exogenous forces on the size of the rents generated by regulation to their initial beneficiaries. Technological progress, especially the dramatic reduction in the real cost of processing and transmitting information, and associated financial innovations are usually mentioned as the most powerful agents of change in the financial sector. Kroszner and Strahan suggest that new technologies in both deposit-taking and lending shifted the political balance of power from small banks towards growth-oriented large banks.[36] This is confirmed by the fact that deregulation occurred earlier in states with fewer small banks, in states where small banks were financially weak, and in states with more smaller and more bank-dependent firms.

In fact, regulation itself was in some cases a driver of change. Government-imposed constraints, by reducing financial firms' utility, provided incentives for them

[36] R.S. Kroszner and P.E. Strahan, 'What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions', *Quarterly Journal of Economics*, 114, 4 (1999), pp. 1437–67.

to circumvent regulation and for their unregulated competitors to disintermediate them through product and process innovations. Innovations, in turn, either led to re-regulation, which may have entailed attempts to bring unregulated products or firms under the existing regulatory regime, or to a relaxation of constraints on regulated incumbents. The latter was especially likely when change was too fast for regulators to keep pace with it and tended to bring the regulated equilibrium close to the unregulated one. This gave more influence to pro-deregulation interest groups and raised demand for deregulation by incumbents as well.

This 'regulatory dialectic' was most evident in the USA.[37] Here, mutual savings banks, which were prevented by regulation from adjusting interest on deposits to unusually high and volatile interest rates, suffered from serious disintermediation in the 1960s and 70s in favour of unregulated institutions such as money market funds. The ensuing disruption of the mortgage market and the building industry created the conditions for the deregulation of thrifts and savings banks in 1980. Likewise, regulated commercial banks were increasingly disintermediated in their wholesale business by non-depository institutions and alternative markets (such as Treasury bonds and commercial paper). A first circumventing reaction was a product innovation, the Certificate of Deposit (CDs), which US regulatory authorities then re-regulated. A second circumventing response was regulatory arbitrage. US banks 'invaded' the City of London and used their foreign branches to intermediate dollar-denominated deposits and CDs – the so called Eurodollars. This became an unregulated international money market towards which British authorities maintained a hands-off attitude insofar as its activities remained confined to external intermediation (cross-currency and cross-country), with no impact on the external situation of the British pound, and regulation succeeded in keeping British banks largely out of the business. Again, US regulators responded to strategic foreign branching by introducing penalty reserve requirements on funds borrowed in London.[38]

The rise of pressure for deregulation gained momentum as from the 1980s. In the USA, time-honoured pillars of the old regulatory regime were eroded and finally brought down. Under the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Depository Institutions Act of 1982, ceilings on deposit interest rates were removed and the traditional

[37] E. Kane, 'Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation', *Journal of Finance*, 36, 2 (1981), pp. 355–67; and idem, 'Technological and Regulatory Forces in the Developing Fusion of Financial-Services Competition', *Journal of Finance*, 39, 3 (1984), pp. 759–72.

[38] On the impact of regulation on the emergence of the Eurodollar market, see S. Battilossi and Y. Cassis (eds), *European Banks and the American Challenge. Competition and Cooperation in International Banking under Bretton Woods* (Oxford, 2002); and especially R. Sylla, 'US Banks and Europe. Strategy and Attitudes', pp. 53–73. On the discussion among central bankers, G. Toniolo, *Central Bank Cooperation at the Bank for International Settlements, 1930–1973* (Cambridge, 2005), pp. 452–71.

banking system deregulated in order to promote competition. The Neal-Riegle Interstate Banking Act of 1994, which had for twenty years codified at national level the effect of state-level deregulation, lifted geographic restrictions on branching. Finally, the firewalls erected by the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956 between commercial and investment banking and insurance companies were demolished (Gramm-Leah-Bliley Act of 1999). Again, federal legislation sanctioned what many state legislatures and banking authorities had been increasingly allowing, by expanding banks' powers and paving the way for a return to universal banking and the creation of giant financial conglomerates.[39]

In Western Europe, equally profound changes took places both at national and regional levels. Competition was promoted and scope and scale in banking enhanced by removing 'conduct' regulations on interest rates and bank portfolios, as well as by gradually lifting restrictions on entry, branching, mergers and acquisitions (M&A), ownership and activities in securities and insurance.[40] Capital controls were lifted earlier and more comprehensively in countries, such as the USA and West Germany, which had resorted to capital controls only as emergency devices in the turmoil of the mid-1970s. Long-standing exchange and capital controls were also swiftly removed in the UK by 1979.[41] On the Continent, liberalization was slowed down by macroeconomic adjustment and disinflation in the first half of the 1980s and controls were, therefore, phased out more gradually and controversially. Countries such as Italy, Spain and Portugal only reluctantly accomplished full financial liberalization in the early 1990s under the political pressure generated by the EU Single Market programme.[42] National capital markets entered a phase of rapid expansion and deep institutional transformation. In the UK, the 'Big Bang' of 1986 precipitated a sudden change in the microstructure of the London Stock Exchange against the interests and the restrictive practices of traditional incumbents ('Old Boys') and in favour of foreign competitors.[43] This turned the City into the world leading financial centre, while on the Continent,

[39] Federal Deposit Insurance Corporation (FDIC), *History of the 1980s. Lessons for the Future*, vol. 1, *An Examination of the Banking Crises of the 1980s and early 1990s* (Washington, 1997), pp. 87–135. See also K. Spong, *Banking Regulation. Its Purposes, Implementation and Effects* (Kansas City, 2000).

[40] For a survey, see E.P.M. Gardener and P. Molyneux, *Changes in Western European Banking* (London, 1994).

[41] R.C. Marston, *International Financial Integration. A Study of Interest Differentials between the Major Industrial Countries* (Cambridge, 1995), pp. 43–69.

[42] A.F.P. Bakker, *The Liberalization of Capital Movements in Europe. The Monetary Committee and Financial Integration, 1958–1994* (Dordrecht, Boston and London, 1996), pp. 147–212.

[43] R. Michie, *The London Stock Exchange. A History* (Oxford, 2001), pp. 543–95.

Paris, Frankfurt and Amsterdam also acquired a new international status and set in motion a competitive dynamic.[44]

The end of financial restriction has brought prudential regulation to the forefront of policy-making again. But financial globalization has also raised the challenging issues of regulatory convergence and competing regulatory jurisdictions, especially in Europe. Safety nets remain the result of policy rules formulated and implemented mainly at national level. In the process of creating a Single Market for financial services, the second EU Banking Directive of 1989 allowed the harmonization of minimum standard prudential requirements. Since 1992 most European countries have adopted the so-called 'Basel I' agreement, a prudential regulatory framework based on minimum capital requirement approved in 1988 by the Basel Committee on Banking Supervision at the Bank for International Settlements. Within the EU, the principle of mutual recognition has removed all regulatory barriers to the emergence of a single banking market and created a level playing field for universal banking.[45] At the same time, banking supervision has remained decentralized in the hands of national regulators with very different approaches. Some central banks, in Italy, Spain, Portugal, Greece, and the Netherlands, have retained it, while other EU countries have opted for integrated financial sector regulators. Since the early 20th century, Sweden has had a single regulatory authority, the Royal Inspectorate of Banks and Securities, exercising supervision of commercial banking, securities trading and stock-exchange operations and since 1991 also incorporating supervision of insurance. This model was adopted by the UK in 2000, when the Financial Service Authority, an independent and non-governmental body, took over banking supervision from the Bank of England, and financial-market regulation and supervision from the London Stock Exchange. Later, a similar pattern was adopted by Germany, with the merger, in 2002, of the Federal Banking Supervisory Office and the Federal Securities Supervisory Office into the newly created Federal Financial Services Authority.

A more fragmented situation has emerged in the regulation of financial markets. All European countries have adopted new prudential regulation on disclosure, listing, Initial Public Offerings (IPOs), M&A, and insider trading. The EU, through the Investment Service Directive of 1993, has allowed national governments to keep their own legal and regulatory frameworks, hoping that mutual recognition would suffice to deepen financial-market integration. However, scope for regulatory arbitrage and competition has remained large, and

[44] W. Seifert et al., *European Capital Markets* (Basingstoke, 2000), pp. 87–107.

[45] J.-P. Danthine, F. Giavazzi, X. Vives, E.L. von Thadden, *Monitoring European Integration*, vol. 9 (London, 1999); E.P.M. Gardener, P. Molyneux and J. Williams, 'Competitive Banking in the EU and Euroland', in A.W. Mullineux and V. Murinde (eds), *Handbook of International Banking* (Cheltenham, 2003), pp. 130–55.

the transposition of EU directives into national laws has been extremely slow.[46] The Lamfalussy Report of 2001 identified about 40 public authorities dealing with securities-market regulation and supervision, with mixed competences and different responsibilities. It also emphasized that the development of integrated European securities markets and the implementation of the mutual recognition system was being held up by the absence of clear Europe-wide regulation on critical issues such as prospectuses, cross-border collateral, market abuse and investment service provision. It pointed to the lack of an agreed interpretation of European rules and to differences in bankruptcy and judicial procedures, taxation, corporate governance and competition policies, listing and disclosure requirements, and takeover rules.[47]

As a matter of fact, the widened geographic, functional and organizational scope of suppliers of financial services has led to the emergence of what Edward Kane has called 'an international market for financial service regulation'.[48] On the one hand, rivalry between private and public suppliers of financial regulation across countries may have protected borrowers, depositors and investors from the over-regulation produced by a monopolistic supplier or a regulatory cartel. On the other, this fragmentation has also magnified the uncertainty about the size of implicit or explicit insurance subsidies guaranteed by national parent authorities to increasingly internationalized risk-bearing institutions. Any failure to meet these implicit guarantees could dangerously shake confidence in the global financial architecture, lead to shrinking foreign trade in financial services and push governments back to old and new policies of financial restriction. For this reason, all players (both regulated and regulators) have a partial community of interest in order to avoid financial instability.

Playing this kind of cooperative game has not proved an easy task, however. Indeed, in chapter 8, Catherine Schenk (*The Regulation of International Financial Markets from the 1950s to the 1990s*) shows, through the lenses of US and British records, how difficult and controversial it was for monetary and financial authorities of industrialized countries to find a common ground for a cooperative solution to the regulation and supervision of international banks. Early attempts were dominated in the 1960s and early 1970s by the discussion on how to bring under control the unregulated Eurodollar market based in London, but operated mainly

[46] See the papers collected in J.M. Kremers, D. Schoenmaker and P. Wierts (eds), *Financial Supervision in Europe* (Cheltenham, 2003); and in particular C. Goodhart, 'The Political Economy of Financial Harmonization in Europe', pp. 129–38.

[47] *Lamfalussy Report* (Final Report of the Committee of Wise Men on the Regulation of European Securities Markets), 15 February 2001, pp. 10–12.

[48] E. Kane, 'Competitive Financial Reregulation. An International Perspective', in R. Portes and A. Swoboda (eds), *Threats to International Financial Stability* (Cambridge, 1987), pp. 111–45; and idem, 'Tension between Competition and Coordination in International Financial Regulation', in C. England (ed.), *Governing Banking's Future. Markets vs Regulation* (Boston, 1991), pp. 33–47.

by US and other foreign banks. The debate generated much heat but virtually no practical result. Both the US and British authorities reached the conclusion that the benefits (providing relief to US banks and corporations in times of domestic credit stringency and enhancing London's status as an international financial centre) largely outweighed its inflationary potential and the destabilizing consequences of short-term capital flows. Subsequent debate among central bank officials at the Bank for International Settlements on cooperative regulation and supervision of the Eurodollar market and the provision of lender-of-last-resort facilities to international banks proved equally inconclusive. Only later, with the 'Concordats' of 1975 and 1983, did an agreement emerge regarding the division of supervisory responsibility on multinational banks between parent and host authorities. The adoption of the Capital Adequacy Requirements issued by the Basel Committee in 1987 (the so-called 'Basel I') represented the only cooperative success in almost thirty years of attempts. But, as Piet Clement gloomily argues in chapter 9 (*The Missing Link: International Banking Supervision in the Archives of the BIS*), historians interested in investigating the making of such agreements are likely to be denied access to most of the BIS records for a long time ahead on grounds of confidentiality and sensitivity. They will just have to content themselves with the background material released by the Basel Committee.

A general consensus exists that from the mid 1970s, and in the wake of thirty years of unusual financial stability, the frequency of systemic or near-systemic banking crises has increased as a consequence of the process of deregulation and liberalization. This was often accompanied by serious currency crises and is not only true of developing countries, but also of industrialized ones.[49] Three of the 'Big Five' systemic banking crises suffered by industrial economies took place in Europe and were preceded by financial liberalization: Norway in 1987 and Finland and Sweden in 1991.[50] The US Savings and Loans crises of the 1980s – an episode of comparable magnitude – also affected a recently deregulated sector of the banking system. In all these cases, competition induced deregulation and unsound practices and excess risk taking ensued, compounded by long expansionary cycles in asset prices. Their reversal eventually led to widespread losses and failures, with governments obliged to intervene in order to bail out distressed financial institutions. Indeed, financial liberalization seems to have brought about the re-emergence of boom and bust cycles, with longer expansions in credit and asset prices, followed by sudden, disruptive contractions. Consumption and investment decisions by no longer credit-constrained households and firms seems to have

[49] M. Bordo and B. Eichengreen, 'Is our Current International Economic Environment Unusually Crisis Prone?', in D. Gruen and L. Gower (eds), *Capital Flows and the International Financial System* (Sydney, 1999), pp. 18–74. See also the papers included in G. Caprio, J.A. Hanson and R. Litan (eds), *Financial Crises. Lessons from the Past, Preparation for the Future* (Washington DC, 2005).

[50] C. Reinhart and K. Rogoff, Banking Crises. An Equal Opportunity Menace, NBER Working Paper no. 14587, 2008.

responded, to an unprecedented extent, to highly pro-cyclical perceptions of wealth and risk, leading to a build-up of financial imbalances – that is, overextensions of private balance sheets – which eventually unwound under the pressure of confidence crises or of monetary intervention of an anti-inflationary nature.[51]

In the last chapter of the volume, Peter Englund and Vesa Vihriälä (*Banking Crises in the North: A Comparative Analysis of Finland and Sweden*) dissect the dynamics of the Swedish and Finnish banking crises of the early 1990s. Both banking systems emerged in the 1980s from a long period of tight regulation just to enter a lending boom driven by increased bank competition, improved access to foreign funds, increased demand for credit by once credit-constrained households and small firms, and asset-price escalation. When in 1990–91 the cycle was reversed, asset prices began to fall and the boom turned into a bust, bringing down finance companies and banks heavily exposed to the housing market. However, Englund and Vihriälä argue that the roots of the crises cannot be traced back exclusively to liberalization, weak supervision and excess risk-taking during the credit boom. In fact, the reversal was exacerbated by a combination of exogenous shocks (such as the collapse of the Soviet Union market for Finnish exporters) and policy mistakes. In the case of Sweden, the mistake was the decision to defend the fixed exchange rate of the Krona during the turmoil of the EMS crisis of 1992. In the Finnish case, the decision to devalue (instead of floating) the Markka in 1991 forced monetary authorities to keep interest rates high in order to defend the exchange rate from new speculative attacks. The floating of the Markka was only delayed, but the devaluation hit hard the foreign-currency debt of the corporate sector, inflicting further losses on the banking sector.

At the present time, the world appears to be on the verge of a vast movement towards encompassing financial regulation, which will probably configure something akin to the Great Reversal which swept most countries during the 1920s and 1930s. A general need is naturally felt for a crystal ball in which to read the signs regarding the nature and direction that matters in this respect are likely to take. Whether a policy-maker, a practitioner or just a member of the public, the attraction of a volume on the history of financial regulation and de-regulation will thus lie for many in the hope that the lessons of the past may be helpful in trying to understand what this second Great Reversal is likely to contain.

Can the knowledge gleaned from these chapters place one in a better position for predicting the shape of the financial world and of the rules that will mould it? The safest answer is probably not. True, in retrospect it is evident from practically all of these studies that path dependence has been one of the most powerful influences over the secular course of relations between financial activity and the regulatory responses they elicit. Yet it is also clear that at each turn in this historical process there is much also that is far from being time-invariant. New,

[51] C. Borio and P. Lowe, Asset Prices, Financial and Monetary Stability. Exploring the Nexus, BIS Working Paper no. 114, 2002; and C. Borio and A. Filardo, Back to the Future? Assessing the Deflation Record, BIS Working Paper no. 152, 2004.

never experienced circumstances incessantly arise thanks to human ingenuity in devising ways of reducing risk, gaining informational advantage, combining resources and creating and exploring technology. As society moves along its course, at each crisis the combination of conditions is never the same as before and the defensive response of markets, of institutions and of society as a whole is therefore always likely to be unexpected and even unexpectable. Past patterns of financial regulation consequently do not evolve in linear fashion and extrapolation from earlier experiences is a risky exercise.

In trying to grasp the future state of global and national financial systems, delving into the past need not, however, be pointless. The chapters in this volume, although unlikely to supply a basis for rigorous projection from past trends and exact predictions, still provide useful and thought-provoking indications. They can suggest the sorts of events that trigger off the critical situations which eventually give rise to the necessity for regulatory swings – wars, of course, but, more frequently, jumps in technology, productivity changes, shifts in paradigms and perceptions, to name a few. Knowledge of previous experiences will point to the probable shape of corrective actions that may be expected from a particular conjugation of circumstances. It will also show that these political outcomes are not just the result of a cool analysis of the facts, even when these are fully known. They can be powerfully shaped also by the heat and indignation released by public debate and by changing popular perceptions of what is admissible behaviour in the realm of finance. In this perspective, it is not difficult to imagine that the coming wave of regulation will not only be appropriate to current problems but will probably go too far and last longer than necessary, as well as following paths which a dispassionate analyst would not have recommended.

A final strand of thought suggested by this volume is that the financial world may be about to be entering waters less known to us than on similar occasions before. For the ills of globally integrated markets, obviously only global remedies will work. This means that in dealing with markets which have overreached themselves, the past is not a particularly helpful guide, a fact that is demonstrated by these studies, all of them essentially national in character. Financial regulation and de-regulation has always been the work of sovereign states, even though it has often been replicated across borders, as a result either of the inclination to emulate best practices or of the need to compete institutionally with rival systems in other countries. An intense reversal of the vast sweep of de-regulation of the last two decades, such as is now expected, is therefore a novel experience. The scarcity of significant precedents for supra-national solutions in a domain where sovereignty has always dominated points to a large area of uncertainty ahead and to a considerable scope for regulatory and political creativity. It is likely that what is in store then is an entirely new regulatory era, which, on past showing, will undoubtedly last for at least one or two generations before another Great Reversal makes its presence felt.