Chapter 3

International Competition in Banking and Financial Services

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International Competition in Banking and Financial Services

SUMMARY

Over the postwar period, few international businesses have grown as rapidly as banking. For 20 years or more, rates of expansion on many measures have been in the range of 20 percent per year. National capital markets have become more tightly integrated, mirroring linkages among banks and other financial institutions. More than 150 U.S. banks maintain branches overseas; Citicorp alone operates in more than 90 countries. Foreign banks have reciprocated, opening new offices throughout the United States.

Truly international capital markets have led to a broad range of new financial products, some of them listed in table 8 in chapter 2. Many of these new products have been introduced in the so-called Euromarket. This offshore or external market, relatively free of the restrictions and regulations that governments normally place on financial transactions, has become a highly desirable alternative for businesses seeking to place or to raise funds. Because the Euromarket is efficient, costs for both lenders and borrowers are low. Firms can issue financial instruments (e. g., bonds, notes, commercial paper) in dollars or almost any other currency. In a typical transaction, the London office of the U.S. securities firm Prudential Bache raised a total of 4.3 billion yen (about $16,7 million) early in 1985 for the Japanese robotics manufacturer Dainichi Kiko through placements with seven institution] investors in Europe.[1]

Two primary forces lie behind much of the growth and change in international banking: deregulation, and new technologies. The United States has been a leader in both, with generally positive impacts on U.S. international competitiveness in financial services. (While this chapter focuses on companies that identify themselves as banks, boundaries between banks and other financial firms have blurred; OTA has not attempted to maintain hard and fast distinctions by firm or by product.) Laws and regulations constraining banks have been relaxed or repealed. Looser regulation means opportunities for new products. Deregulation, by increasing competition, also drives down profit margins, inducing some banks to take greater risks in the hope of maintaining profitability. Governments everywhere stand behind the safety and stability of their banking systems; plainly, deregulation will only go so far. Governments will also continue to influence banking activities as they pursue macroeconomic policy and control of the money supply. The relationships between public and private sectors in banking are unique among industries.

Financial service firms have been major users, but not originators, of postwar advances in computer and communications systems, Thus technology—the other major driving force—has been an independent factor. Deregulation permits firms to broaden the scope of their financial activities; technical advances make it possible to do so efficiently, and on a global scale. Banks turned to computer technology, first, to help manage their vast flows of paperwork. Strategic applications came later, complementing back-office automation (ch. 8), with banks looking to technology for help in escaping from government regulations; offshore Eurobanking, perhaps the preeminent example, began in the early 1950s, but it was electronic funds transfers that freed offshore markets from fixed geographic locations, opening them to worldwide participation.

Today, a large American company can arrange a loan in Tokyo or place a security denom-

'11', Dawkins and J. Shibata, "A Japanese Upset for Venture Capitalists," *Financial Times*, Oct. 28, 1986, p. 28. Dainichi Kiko entered bankruptcy the next year.

inated in yen and swap the currency into dollars to be spent in the United States (or marks to be spent in Germany), at the same time swapping a fixed interest rate for a variable rate—a transaction that, while not unheard of, would have been unusual as recently as 1980. Funds flow across national boundaries as never before, and national financial systems have become tightly interwoven. Once, the effects of a major failure would have been isolated within the bank's home country; today, they could ripple around the world. While steps taken in the past few years have allayed much of the immediate concern over stability of the world financial system, future developments could easily lead to renewed fears of worldwide banking collapse.

This chapter examines competition in international financial services, in both offshore and onshore markets. (Onshore banking refers to operations in national markets by foreign-owned banks—for instance, Japanese banks in the United States.) With the need to focus on international banking, and the competitiveness of U.S. financial services firms, OTA has not been able to give much space to the well-publicized changes taking place in domestic retail banking, although many of these have also been driven by the twin forces of deregulation and new technologies; in U.S. retail banking, the half-dozen standard products of a decade ago have given way to a hundred or more.

The sections that follow highlight four major points:

1. The maze of U.S. banking regulations—implemented by the States as well as by Federal agencies—exerts wide-ranging impacts on the international competitiveness of the U.S. financial services industry. Rapid expansion of international banking makes these impacts much more important than just a few years ago, but policy makers give them little consideration. OTA's analysis indicates *a need for the policymaking process to reflect, on a routine rather than exceptional basis, the impacts of Federal policies on the international competitiveness of the U.S. financial services industry.*
2. Regulators confront moving targets as technological change and competitive pressures lead to continuous restructuring in world financial markets. Increasingly integrated but decreasingly regulated markets pose greater dangers of instability and world banking collapse. National regulations intended to protect depositors and ensure stability have self-limiting effects; in a competitive world, they drive banks to seek unregulated markets and unregulated products–a dynamic that can lead to greater risks. U.S. leadership in seeking greater *international coordination of banking supervision and banking regulation* could help move the system toward a more stable footing. (To some extent, the decrease in regulation has been accompanied by an increase in supervisory oversight by government bodies—i. e., by monitoring rather than control.)
3. External markets have grown as providers of capital search for higher returns, while corporate borrowers seek lower financing costs, Not long ago, corporations went to the Euromarkets for bank loans to support their foreign subsidiaries. Today, they look to these markets for securitized financing —bonds and stocks, commercial paper that can be traded in secondary markets—to finance domestic as well as foreign operations. *Securitization—the replacement of loans by marketable securities—has permanently changed the environment for international competition.* The consequences make competitive life more difficult for U.S. banks.
4. Only the Japanese seem in a position to challenge American financial services firms. As Japan's financial markets become more fully integrated into the world system—in part as a result of prodding by the U.S. Government—Japanese *financial institutions will mount major competitive challenges.* While it is too early to predict the outcomes, it is not too early to take account of this new source of competition in implementing Federal policies. For example, it is not at all clear that U.S. pressure aimed

at opening up Japan's capital markets is in the longer term interest of the U.S. financial services industry.

In such a world, can the Federal regulatory and supervisory system continue to cope? This chapter suggests that, at the very least, the system needs modification to bring national and international considerations into better balance.

As they have evolved since the 1930s, U.S. banking policies, at both State and national levels, have generally been focused quite narrowly on the particular problems of a particular time. The policies themselves emanate from a bewildering assortment of State and Federal authorities (including, at the national level, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC)). Rarely have either State or Federal agencies examined the possible impacts of their actions on the international competitive standing of U.S. banks, even though in many cases these impacts are real and apparent. The FDIC, for instance, establishes premium levels with little effort at coordination with other governments; yet international differences in these premiums alone could place U.S. banks at a competitive disadvantage.

One of the policy options in chapter 10 (option 13) would establish mechanisms for monitoring and coordinating the actions of Federal agencies as they affect the international competitiveness of the U.S. banking industry. This is not to suggest that these impacts should dictate policy, but that they should take their place with other considerations as a normal part of the policymaking process.

National banking regulations exist in part to foster confidence in the security of deposits and in the continuing viability of the system as a whole. But continuing restructuring of world financial markets, driven in part by advancing technology, can quickly make the regulations of any one country obsolete. New products, many of them securities, continually stretch the boundaries of the permissible. With sources of interest income remaining more heavily regulated than fee-earning services, banks develop new products that replace loans with other sources of earnings. As banks and other institutions develop new forms of financing, regulatory officials find themselves chasing moving targets. When the regulatory agencies react to their innovations, the banks move off in another direction.

In the United States, the responsibility for monitoring and for implementing regulatory policies shifts between agencies as new forms of financing spring up, with ultimate authority becoming diffused and confused. The problem is little different in other national markets. Internationally, the situation is still messier; regulatory structures, where they exist, remain poorly developed. The growth of offshore markets makes regulations in any and all countries less effective because financial institutions have more ways of avoiding them. Although the banks themselves benefit from a stable international environment, they have been more concerned with narrow questions that affect their ability to compete with one another. Banks and national governments are in similar positions: individually, they can do little to preserve stability internationally.

In this climate, governments have begun to consider methods for coordinating and harmonizing their regulatory and supervisory practices. The Federal Reserve and other U.S. authorities have opened discussions on the possibility of international rules for external markets. Recent proposals for a bilateral agreement with the United Kingdom (U. K.) on capital requirements may be a first step towards broader arrangemerits.[2] OTA's analysis points not only to the need for continuing such talks, but to the need for a thorough study of sources of possible instability.

If coordination of regulations might help, national interests will inevitably differ and widespread agreement may be hard to achieve. At this point, it is not even clear that appropriate international forums for negotiation exist. Over the past few years, the Basel Committee, an advisory group of central bankers and super-

[2]See D. Lascelles, "Britain and U.S. Agree Landmark Banking Pact," *Financial Times*, Jan. 9, 1987, p. 1, and related stories on pp. 6 and 18.

visory officials from fewer than a dozen major nations, has provided a place for discussion, but the Committee would not necessarily be the proper setting for negotiations among governments. In chapter 10, OTA suggests steps that would help focus attention on questions of international coordination and the further development of an international regime for the supervision of financial services.

what then of U.S. international competitiveness in banking? Securitization—replacement of bank loans by securities as preferred sources of corporate financing—has made deep and permanent changes in the competitive environment, Investment banks have become much more prominent in international markets because of their experience in structuring new securities issues; rapid growth has led U.S. investment banks, which remain small compared to commercial banks, to seek new capital—sometimes foreign—in order to keep pace with market expansion. At the same time, where permitted, U.S.-based commercial banks have plunged into investment offerings (regulations restrict this in the United States). U.S. commercial banks have also sought other sources of income to supplement their international lending, Some of these fee-based products—e. g., foreign exchange trading, interest rate swaps—could turn out to be riskier than anticipated.

OTA's analysis suggests that the competitive changes caused by securitization threaten the competitive position of individual banks more than that of the U.S. industry as a whole. Indeed, relative to foreign industries, the American financial services industry has done well in the rapidly shifting competitive environment of the past few years. American banks have been able to take advantage of learning and experience in their deregulated home market ahead of major foreign competitors; some of latter have invested in the United States primarily to gain experience. From all recent signs, U.S. international competitiveness in banking and financial services will remain strong. This does not mean, of course, that all American banks will do well internationally. This is an industry with many competitive firms. Some do well in some markets, some do well in others. Products are similar, technology—though not the expertise to use it—easy to come by. New financial services arise in part as banks struggle to differentiate themselves and become something other than purveyors of commodity-like products. No one can count on decisive sources of advantage or sure success in the future.

There seems only one real threat to the competitive rank of the U.S. financial services industry—Japan. Japanese banks, almost invisible 15 years ago, have become major players on the international stage, Because of continuing and massive bilateral trade surpluses with the United States and other industrial nations, Japan has become a huge international creditor, particularly in dollar-denominated financial assets. Japanese banks now hold more international deposits than their American counterparts, and far surpass any other national industry. The competitive thrusts of Japanese banks show greater sophistication today than even 2 or 3 years ago,

Yet Japanese competition has thus far made few major differences for U.S.-based financial institutions. American banks have been aggressive, innovative, and efficient—qualities that have enabled them to maintain their international position in an increasingly deregulated global environment, Could all this change, in the way it did for manufacturing industries like automobiles or consumer electronics? Could the Japanese exploit new competitive opportunities to carve out ever-larger shares of international markets? Do their onshore investments in the United States represent competitive strategies aimed at the home markets of American banks? while not impossible, and while some signs point in this direction, parallels between markets for financial services and manufactured goods can easily be overdrawn.

Banking has been a highly competitive international industry for decades, with many firms from many countries competing in a least some parts of the market. In such industries, few of the forces affecting competitiveness, in isolation, make a big difference (the way technical skills do in the commercial aircraft industry, or scale economies once did in automobile production). American banks have not been insular or insulated; they have capitalized effectively on advantages where they could find them, just as foreign banks have, Competition between the United States and Japan seems bound to intensify, with the pace largely controlled by Japan's willingness to liberalize its financial markets. The competitive threat is real, but careful monitoring of relative positions seems the appropriate response for the moment,

GROWTH AND COMPETITION IN INTERNATIONAL FINANCIAL SERVICES

Banking—the second-oldest service—was also one of the earliest to be traded internationally. Trade in goods still requires financing, but international banking today hardly resembles the industry of even a decade ago. Looser regulatory structures have bred greater competition among more banks in more parts of the world. No longer can banks live comfortably within sheltered regional or national markets. Protective barriers offered one of the few sources of decisive advantage in a business with many able competitors, quick to copy good ideas. Although much of the business continues to revolve around trade-related instruments like letters of credit and banker's acceptances, new products —particularly those sold in lightly regulated or unregulated external markets—have grown at an explosive pace, Here, the banks that have gotten in first have generally been able to maintain leading positions.

Market Dynamics

International banking deposits (as defined in table 11) have grown much faster than world trade [i.e., total world exports of goods and services). In most countries, international banking has also grown more rapidly than domestic banking; for the nations of the Organization for Economic Cooperation and Development (OECD), the ratio of foreign to domestic liabilities more than doubled during the 1970s, and has continued to rise, albeit more slowly,[3] During the 1970s, banks everywhere found their profitability slipping in traditional markets, Early responses included heavy lending to newly industrialized and less developed countries (NICs and LDCs), and to Eastern Europe. Rising oil prices meant large trade surpluses in some countries and large deficits in others; banks could get funds from oil exporting countries, extend loans to importing countries, and expect handsome profits. These loans grew to become a significant part of the portfolios of many major banks before the shortcomings of the strategy became clear to all.

During this period, American banks did about 27 percent of the total syndicated lending to these countries, about the same as their percentage of worldwide assets.[4] Worldwide reces-

Table 11.—Growth Rates of International Banking Compared to World Trade

	Annual rate of growth		
	1966-73	1973-80	1980-84
Total international banking deposits[a]	30.0%	24.4%	6.6%
Total world exports	9.2	25.2	–1.5

[a]Equal t. the sum of domestic and foreign currency liabilities to nonresidents of all banks world wide, plus their foreign currency ha abilities to residents

SOURCES *Annual Report Bank for International Settlements* (Basel, Switzerland Bank for International Settlements. various years], *International Financial Statistics* (Washington, DC International Monetary Fund various years)

[3]R. M. Pecchioli, *The internationalization of Banking: The Policy Issues* (Paris: Organization for Economic Cooperation and Development, 1983), p. 16.

To take a different kind of indicator, the number of major banks having offices in banking centers outside their home countries increased from about 300 in 1970 to 550 in 1980— *The Bankers Almanac and Yearbook,* 1970-71 and 1980-1981 (New York: I.P. C, Business Press Limited).

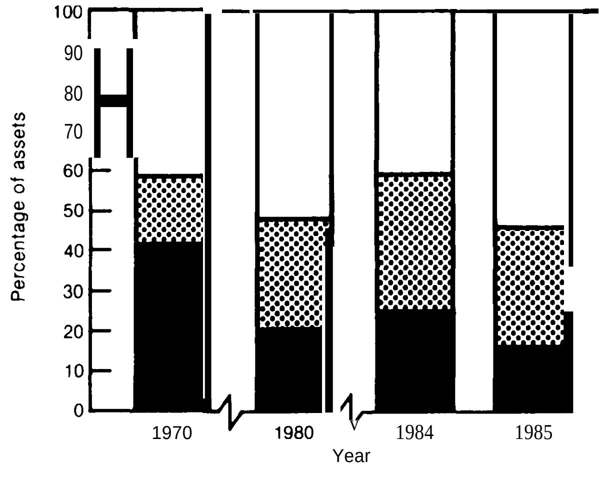
[4]"International Bank Lending Trends, " *World Financial Markets (New* York: Morgan Guaranty, July 1985), pp. 5, 7,

By the end of 1986, Brazil's foreign debt stood at about $108 billion and Mexico's at $100 billion. Among countries seeking rescheduling, these two are followed by Argentina ($50 billion], Venezuela ($35 billion), and the Philippines ($27 billion]. Major lenders to these countries include Citicorp (the largest single lender to Brazil and Mexico), Manufacturers Hanover, BankAmerica, and Chase; each of these banks has loans outstanding to Brazil that total more than half of its shareholders' equity. Ten or more U.S. banks have outstanding Latin American loans totaling more than their equity. See P. Truell, "Citicorp's Reed sion and falling oil prices, along with less than prudent loans, make repayment of principal and in some cases the interest on many of these obligations uncertain. In worst case defaults, the capital of even large money-center banks could be wiped out, leading to a crisis **at** the lending bank or banks; beyond ongoing risks of defaults, the major implication for competitiveness is that banks with high levels of risky international debt will have limited strategic options.

Big banks take most of the business in international financial services; perhaps two dozen firms with headquarters in the OECD nations account for more than half of all cross-border lending, and some 60 percent of lead managements of bonds and other securities issues. s Among these banks, positions have been changing. As figure 20 shows, the assets of the largest Japanese banks have been growing steadily, and now exceed those of their American counterparts. The relative shifts visible in figure 20 reflect macroeconomic factors such as differing economic growth rates and currency exchange values, among other things, with the increase in U.S. asset share between 1980 and 1984 largely a consequence of the strength of the dollar during that period.

Cross-border assets paint much the same picture. At the beginning of 1986, Japanese banks for the first time held more international deposits than U.S. banks—a gap that widened quickly during the year as the dollar weakened. As figure 4 (in ch. 1) showed, banks from other countries trail far behind. The rapidly rising assets in the Japanese financial system stem in large part from Japan's consistently high trade

Figure 20.—Relative Asset Shares of the World's Largest Banks[a]



[a]300 largest banks for 1970-84; 500 largest fOr 1985

SOURCES 1970.84: *The Banker* (various issues); 1985: "30th Annual Survey of the World's Top 500 Banks, Part 11, " *American Banker,* July 30, 1986, pp 36-44

surpluses over the past half-dozen years. It is this growth in assets that, more than any other factor, points toward greater competitive challenges by Japanese banks,

in 1984, the latest year for which comparable data are available, Citicorp remained the largest financial institution in the world as measured by assets, with $190 billion, followed closely by five Japanese banks, the largest of which was Dai-Ichi Kangyo, at about $170 billion.[6] Measured in this way the dominance of Japanese banks as a group appears overwhelming. When measured by profits, however, Citicorp was far ahead, earning almost a billion dollars, compared to runnerup Barclays (British) at $600 million. National Westminster (another British bank), Chase Manhattan, and Manufacturers Hanover all reported greater

(continued from previous page)

Takes Firm Stance on Third-World Debt, " *Wall Street Journal*, Feb. 4, 1987, p. 6; "Risks of Foreign Banks in Latin America, " Financial *Times*, Feb. 25, 1987, p. 4; E.N. Berg, "Brazil's Debt: A Key Juncture, " *New York Times*, Mar. 3, 1987, p. D1.

U.S. banks are particularly affected by Latin American debt problems, with Western European banks exposed in Eastern Europe, and the Japanese in Indonesia. In lending to Brazil, Japan follows the United States, with outstanding long-term loans of $8.8 billion, compared with $18.6 billion for American banks.

[5] P. Mentre, "The Fund, Commercial Banks, and Member Countries, " Occasional Paper 26, International Monetary Fund, April 1984.

[6] " International Banking: Wooing the Customer, " *The Economist*, Mar. 22, 1986, p. 6; "30th Annual Survey of the World's Top 500 Banks: Part I I," *American Banker,* July 30, 1986, pp. 36-44. In 1985, Dai-Ichi Kangyo became the biggest bank in the world as measured by assets, and in 1986 the biggest bank holding company as measured by assets, surpassing Citicorp.

All measures of bank size and profitability reflect dramatically shifting exchange rates, as well as differing accounting principles and banking practices.

profits than the Japanese leader, Sumitomo (which earned less than $400 million).

American banks have generally moved the fastest into fee-based services, many of which generate profits that do not translate into assets, This accounts for some of the disparity between asset and profit measures. Data presented later in the chapter show that U.S. financial institutions have large and often increasing shares of markets for major international banking products, American banks also tend to have many more foreign branches: by Sumitomo's count it has only 40 foreign branches, compared with over 1,800 for Citicorp. In summary, the big U.S. banks, while certainly not dominant, remain competitively strong,

Competition among banks is only part of the story. U.S. banks have new rivals who have entered from outside the financial services industry—not only corporations that place their own commercial paper, but companies expanding into financial services from other industries. Some, like the major department stores with their charge cards, and automobile companies with their financing subsidiaries, have been extending consumer credit for years—and earning healthy profits from these parts of their businesses. More recently, companies like Sears —which purchased Dean Witter in 1981—have sought to use their marketing skills and network of outlets to enter retail markets for financial services. Thus far, entrants from other industries have not had much impact internationally, nor have mergers between financial and nonfinancial firms been outstandingly sucessful; frequently, profits of the merged units have fallen,

Onshore and Offshore Banking

Funds move internationally in two kinds of markets, onshore and offshore. In an *onshore* transact ion—e. g., when an American corporation arranges to borrow yen in Tokyo—foreigners participate through national markets. Onshore banking also takes place when foreign-owned financial institutions enter domestic markets—when a Japanese bank opens offices in San Francisco or New York, or buys an American bank. In *offshore* markets, financial transactions take place largely beyond the regulatory reach of the government issuing the currency of the transaction—the case when an American corporation borrows dollars (or yen) in London. Offshore markets, often called Euromarkets because much of the activity continues to take place in European financial centers, tend in practice to be largely free of regulation by any and all governments; they need have no fixed geographic location, and today could almost be viewed as existing in the telecommunications infrastructure.

In either onshore or offshore markets, flows of funds can be direct or intermediated. In the first case, a broker brings together a buyer and seller of securities (e. g., stocks or bonds). Direct flows of funds in the foreign sector of national capital markets mostly involve bonds, In intermediated transactions, a financial institution, usually a bank, borrows by issuing its own liabilities and lends the money to others.

Today, onshore markets for foreign bonds, concentrated in Switzerland, the United States, and Japan, total about $30 billion; continuing regulatory constraints have slowed growth, contributing to expansion in other financial instruments. Onshore markets for equity (stock) have begun to expand rapidly, although remaining small compared to foreign bond markets. While the shares of relatively few corporations are listed on exchanges outside their home countries—table 12—the numbers have been headed steeply upward, especially among the biggest companies; the 400 firms traded on foreign markets as of mid-1985 may have represented a quarter of the total capitalization of their home-country stock markets, ' It should soon be possible to buy or sell any major stock at any time of day or night through an exchange in Europe, North America, or Asia, The emer-

[7]"The Corporate List," *Euromoney*, February 1986, pp. 168-169. In 1983, corporations raised $83 million through new equity issues in markets outside their home countries—a financing mechanism almost unheard of previously. New Euroequity issues totaled $306 million in 1984, $3.2 billion in 1985, and the same amount in the first 6 months of 1986. See Q. P. Lim, "Equities Enter the Eurobond Age," *Euromoney*, October 1985, p. 262; and S. Lohr, "Turning to Europe for Equity," *New York Times*, Aug. 21, 1986, p. I) 1.

Table 12.—Companies With Shares Traded on Foreign Markets, by Home Country

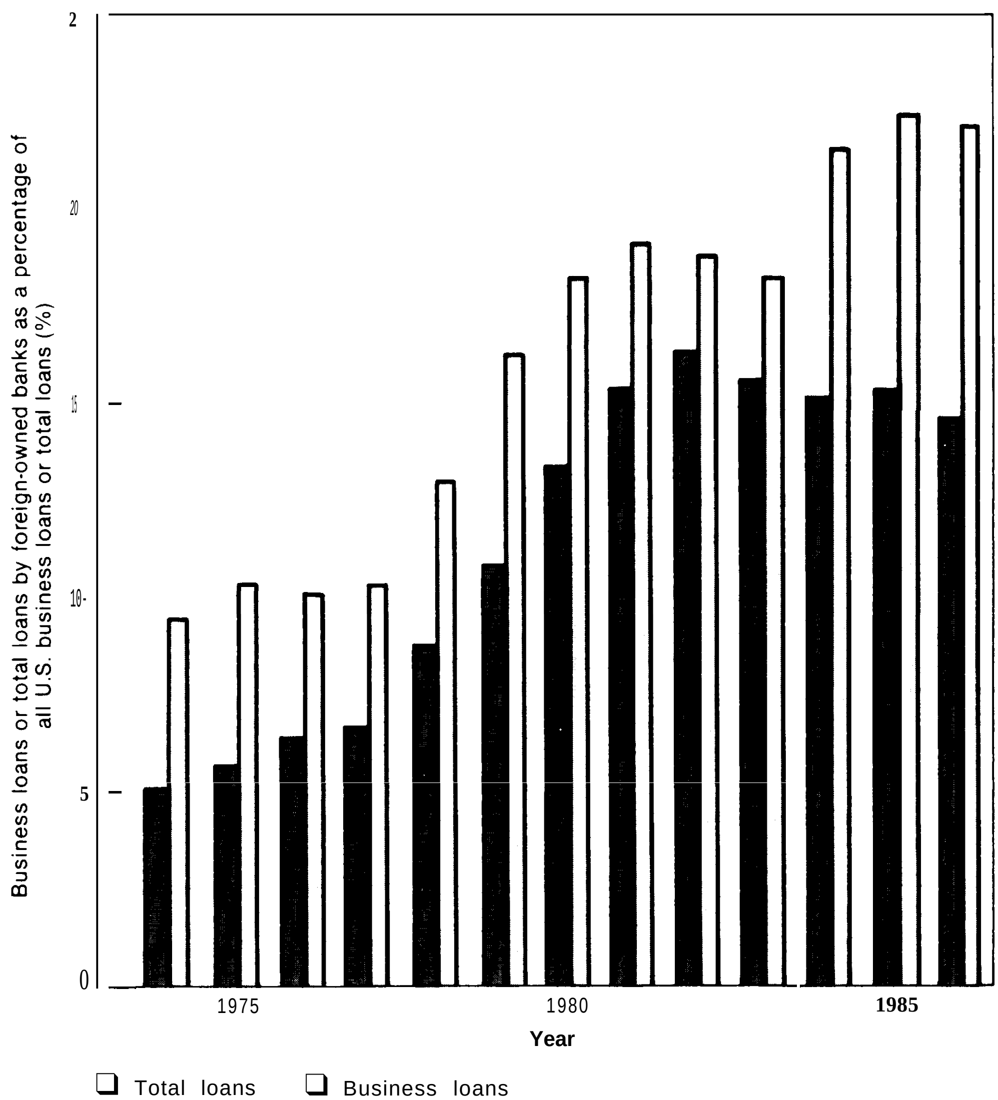
Headquarters location of issuing company	Number of companies December 1983	December 1984	June 1985
United States	84	85	85
Japan	49	65	81
United Kingdom	13	25	33
Federal Republic of Germany	17	22	26
Other	73	131	175
	236	328	400

SOURCE *Euromoney* various issues

gence of foreign markets for stocks promises to be a big step toward fuller integration of capital markets internationally, with dramatic consequences for the underwriting business.

Onshore banking through direct investment has also been expanding, spurred by a loosening of regulatory constraints in countries including Japan, Canada, Sweden, Taiwan, and Australia. Figure 21 shows the steady expansion of foreign bank lending in the United

Figure 21.—Lending in the United States by Foreign-Owned Banks



NOTE. Percentages for December of each year, except June 1988.

SOURCE Federal Reserve Board, unpublished data, November 1986

States. New York, as a major international banking center, has been home to many foreign bank offices for years: Bank of Tokyo's New York office was founded in 1880. But expansion elsewhere, and particularly in retail banking, is a newer phenomenon; Japanese banks have become much more visible in California (Sumitomo Bank of California, California First, Bank of California). In 1975, the foreign assets of U.S. banks (outbound banking investment) greatly exceeded the assets of foreign banks in the United States (inbound); since then, outbound growth has been slow compared to inbound, and today inbound and outbound banking investment are about equal.[8] Box F summarizes reasons for the growing foreign bank presence in the United States, while a later section looks more closely at the strategies of Japanese banks.

The external or offshore markets function quite differently. Eurodollar bonds, to take an example, are denominated in dollars but bought and sold outside the United States, typically in London. Most Euromarket transactions involve the U.S. dollar, but participants (buyer, seller, underwriter) need not have their main businesses in the United States. Likewise, an American bank might underwrite a corporate bond in London denominated in yen that is sold to a French bank and raises money for a Brazilian firm; U.S. laws prohibit commercial banks from underwriting such an issue here.

While London has traditionally been the center of the offshore market, Singapore and New York have seen rapid growth in recent years. Fierce competition has led to reduced operating costs and rapid expansion. In 1965, the Eurodollar market was less than 10 percent as large as the domestic U.S. financial market–$12 billion versus about $170 billion. By 1983, the Eurodollar market had surpassed $800 billion, more than half the size of the U.S. domestic market. Direct financing, mainly Eurobonds, has been growing considerably faster than the intermediated transactions that also take place in external markets. (Lack of regulations and reporting requirements in offshore markets means that their size can often be estimated only roughly.)

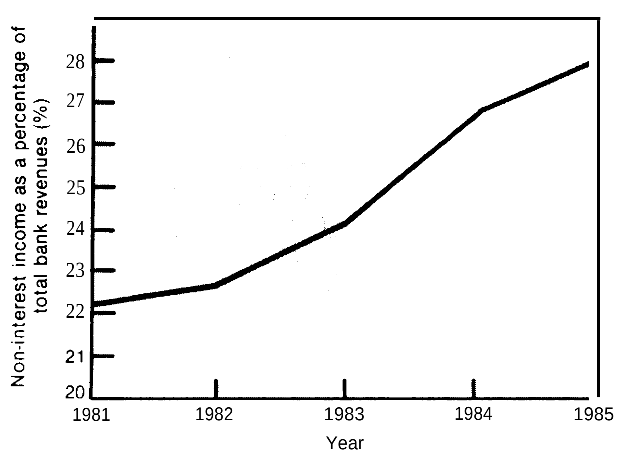
[8] Federal Reserve Board, unpublished data.

Expanding external markets go hand in hand with newer banking products that facilitate international flows of capital (table 8, ch. 2). Telecommunications links (box G) have spurred growth in interest rate and currency swaps, (Swaps, explored more fully later in the chapter, involve the exchange of one financial asset or obligation for another.) The annual volume of outstanding interest rate and currency swaps has grown beyond $300 billion, With these and other new banking products (e.g., standby letters of credit, also described later), banks earn fees for their services rather than interest. As figure 22 shows, fees have been growing relative to interest as a source of revenues for U.S. banks. The shift toward fees is probably greater for international banking than for domestic operations.

Securitization

Perhaps the most striking and most significant change in financing practices—a change that has accompanied the rise of external markets, and contributes to the growth of fee-based services—stems from securitization. A company seeking financing can, in general, do so either by borrowing from a financial institution or by issuing a security such as a bond or stock. Likewise, those with money to invest can deposit funds in a financial institution or buy

Figure 22.—Growth in Fee Income Relative to Interest Income for U.S. banks



SOURCE. *Federal Reserve Bulletin*, September 1986, p 627

Box F.—Foreign Banks in the United States

Figure 21 shows that foreign banks increased their onshore business in the United States quite rapidly during the 1970s. Some of this growth has followed naturally from rising international trade and expansion in foreign economies. Have competitive shifts played a part? Answers to this question begin with the reasons that foreign banks invest in the United States.

The first of these, as in so many industries, is the size and lucrative nature of the U.S. market. New York City is the world's largest center for financial services. Any bank that sees itself as multinational will seek customers among American corporations, along with access to a base of dollar deposits and the discount window of the Federal Reserve System. Not only is the banking infrastructure more advanced here than elsewhere, but financial services have been deregulated ahead of other parts of the world. Foreign banks establish or expand U.S. operations in part to gain experience in a comparatively deregulated environment, one they expect to spread to their home country and to other markets within which they do business.[1] Differences in national regulations also create strategic opportunities; for instance, the mix of U.S. and foreign regulations that apply to branches and agencies in the United States may result in lower costs for some financial service products-e. g., business loans—for some foreign banks. Other reasons for investing in the United States include the following:

- Foreign banks, many of which operate on a nationwide basis in their home markets, may feel that they will have advantages over less-experienced U.S. institutions as interstate banking spreads.
- Until passage of the 1978 International Banking Act and subsequent legislation, foreign banks were treated differently than American banks, arguably to their benefit. Moreover, U.S. antitrust policy has made it easier for foreign banks to purchase troubled financial institutions, or bank units sold for strategic reasons—a quick and easy entry to fundamentally profitable markets. For example, when Bankers Trust decided to reemphasize retail banking in the New York City area in 1979, it sold most of its 106 branches to three foreign banks.[2]
- Some foreign banks, less burdened by risky debt in developing countries than their American competitors, have greater strategic freedom.
- Just as American banks followed American corporations overseas, Japanese and some European banks have moved into the United States to serve their corporate clients.
- Finally, entering the United States will make sense for any bank with reason to believe it can compete; initial-entry into the U.S. market serves as a test. Rapid expansion can follow if the bank finds itself to be highly competitive, or if the fluid environment here should shift in its favor.

Despite the possible sources of advantage mentioned above, the U.S. operations of foreign banks have seldom been particularly profitable.[3] While there are many reasons for foreign banks to seek an onshore presence in the United States, there is little evidence that the expansion illustrated in figure 21 points to competitive advantages over U.S. banks. And of course these banks are not selling services supplied from overseas, but services produced here with the aid of U.S. workers, the U.S. banking infrastructure, and, often, U.S. capital.

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[1] See, for example, K.A. Grossberg, "'Japan Checking Out U.S. Banking Revolution," *Wall Street Journal*, Feb. 6, 1S88, p. 24.

[2] Bank Leumi Trust, National Bank of North America, and Barclays—E. Compton, *Inside Commercial* flanking, 2d ed. (New York: Wiley, 1983), pp. 93-04, 199.

[3] See, for example, N. Gilbert, "Foreign Banks in America: They're Still Coming," *Euromoney* August 1985, pp. 150-156. Of course, banks, like firma in any industry, sometimes choose to sacrifice profits to buy market share.

Box G.—Technology in Banking: Electronic Networks and Cash Management Systems

As in so many of the services, new technologies in banking mean, first and foremost, applications of digital computers and telecommunications systems. Banks have been leaders in applications since computers began to spread in the business world. Today, back-office paperwork functions —e.g., check processing—are highly automated; transactions processed overnight a few years ago can be handled immediately. Larger financial service firms continue to invest hundreds of millions of dollars annually in new software and hardware, with much of the investment now going to support new products rather than the automation of existing operations. Fault-tolerant systems cut down on errors, with some banks investing millions of dollars for backup systems that may never be used—but if needed, could save far greater sums (see the Bank of New York example below).[1]

Banks are also learning to use computers analytically–for risk analysis and decision support —as well as for routine transaction processing. Simple computer programs can calculate a range of possible repayment schedules for proposed loans; complex programs analyze price trends of thousands of Eurobonds each day. Software developed by Bankers Trust reputedly gives the company's foreign exchange traders a 10 second advantage over the competition, enough time to execute four or five trades. Soon, expert systems will be available in the form of computer programs that embody the decision rules followed by experienced foreign exchange traders. The expert system will never be as good as the true human expert, whose storehouse of experience leads to judgments and intuitions that cannot be reduced to rules the computer can follow (ch. 8). But expert systems will help the inexperienced to learn, the inexpert to perform better, and the true expert to avoid errors. Among those recently surveyed, about 20 percent of American financial institutions had already begun to install expert systems, with another 40 percent planning to do so over the next few years.[2]

Networks. -Banks communicate and transfer funds through computers linked to form value--added networks (VANS, ch. 5). Member banks can transmit messages both domestically and across national borders via SWIFT (Society of Worldwide Interbank Financial Telecommunications), which began operations in Europe in 1977 and now links nearly 2,000 locations in over 50 countries. Jointly owned by more than a thousand banks, the SWIFT system currently handles almost a million messages each day.

SWIFT transmits messages between banks, but not funds. These are the province of other computer networks. Normally, any international transfer involving dollars will make use of CHIPS (Clearing House Interbank Payments System), controlled by a dozen large New York banks (the clearinghouse banks) and connecting 140 U.S. and foreign-owned institutions, all in New York City. (Three of the clearinghouse banks—Marine Midland, National Westminster Bank U. S. A., and European American Bank—are subsidiaries of foreign companies.) CHAPS, a similar network in the United Kingdom, serves the large London banks. In a typical transaction:

- Bank A in London has a correspondent relationship with Bank B in New York and wishes to transfer funds to Bank Din Tokyo which has a correspondent relationship with Bank C in New York. B and C are CHIPS members.
- After message traffic between A and B concerning the transaction, perhaps over SWIFT, B enters codes for itself and for the receiving bank C into its CHIPS terminal, along with the sum to be transferred and the identity of bank D.
- The message goes to the central CHIPS computer, where it is stored temporarily.
- The sending bank B must next transmit a verification for the release of funds. The cen-

[1] On backup systems, and applications mentioned in the next paragraph, see R.B. Schmitt, "'The Technology Gamble," *Wall Street Journal*, Sept. 29, 1986, p. 10D.

New technologies used in retail banking-e. g., automatic teller machines (ATMs)—have more visibility but little to do with international competition. Their main effect is on the price and quality of retail services domestically.

[2] "The Future of Technology in the Financial Services Industry, " *American Banker*, Apr. 14,1986, p. 14. Coopers and Lybrand, which conducted the survey, found that more banks than insurance companies, brokerage firms, or investment houses expected to use new technologies like expert systems as competitive weapons. An analyst at Arthur D. Little has estimated that 35 percent of the largest U.S. financial institutions will install prototype expert systems during 1987, compared with 5 percent in 1986—W.M. Bulkeley, "Computers Take on New Role As Experts in Financial Affairs," *Wall Street Journal*, Feb. 7, 1986, p. 23. For further examples of expert systems applications, see B.J. Feder, "The Computer As Deal Maker," *New York Times*, Aug. 14, 1986, p. D2; also, L. Kehoe, "White Collar Robots Go To Work," *Financial Times*, Aug. 5, 1986, p. 9.

tral computer then debits the CHIPS account of B, and credits the account of the receiving bank C (retaining a permanent record). Bank C informs Bank D that the transaction has been completed.

Normally, each of the 140 banks will settle its account with CHIPS at the end of the business day. Final settlements use FedWire-another network, this one operated by the Federal Reserve System. FedWire, which links about 6,300 financial institutions in the United States, nets transactions immediately.

Many other networks also provide electronic funds transfer services, with about 66 automated clearinghouses (ACHs) currently operating in the United States. In contrast to CHIPS, most ACH transactions are relatively small. They also provide services to firms outside the banking industry-e. g., direct deposits of employee paychecks. Other computer networks provide quotations and execute trades of commodities and securities. Non-financial firms can tap into almost any of these systems with an electronic cash management system, as discussed below.

Multinational banks commonly operate private international networks for communications between branches—e.g., Manufacturers Hanover's Geonet. A common pattern consists of service centers in major financial markets, from which further spokes fan out. Hongkong and Shanghai Bank, for instance, operates a telex network linking more than 100 offices in over 60 countries based on leased lines (cable and satellite) and switching centers in Hong Kong, Britain, the United States, Bahrain, and Australia. The company also has a newer computer network, only partially completed, which operates at much higher speeds. Independent vendors such as GEISCO, Telenet, and Tymnet-all of which offer specialized services for banks-provide a further set of alternatives for message communications and securities transactions.

The greater the speed with which message, clearing, and settlement systems function, the greater the opportunities for banks to make profits on certain kinds of transactions. On the other hand, when the time lags between messages, clearing (transactions booked), and settlement (payment made) decline, financial institutions have less chance to take advantage of floats, the de facto interest-free loans made possible by these lags.

Implications for Stability.-Computer networks are never foolproof. A highly publicized failure cost the Bank of New York about $5 million during a 2-day span in November *1985*. The bank, which does a very large business in government securities, normally receives and makes payments on these securities almost simultaneously. A software error in the firm's system left it liable for payments without receiving the corresponding credits. Before discovering the problem, the bank ran up a $32 billion overdraft with the Federal Reserve. The $5 million in interest charges came to about 5 percent of the bank's annual earnings.[3]

As message, clearing, and settlement networks evolve toward greater complexity and greater speed, the probabilities of system failures may not rise, but their consequences certainly will. When, for instance, payments moved through the mail, failure of a bank might be a process taking weeks. Regulatory authorities could monitor the situation and intervene if appropriate. Now a bank could fail almost instantaneously.

Cash Management.–For many years, banks provided services to corporations in exchange for the interest-free use of funds on deposit. With rising interest rates, corporations began to view this as a bad bargain; today, corporate treasurers manage their cash balances and short-term assets much more aggressively, as they have always managed long-term finds. Banks have been faced with the loss of more than the interest income. Many of their traditional customers now have the ability to manage their own cash, should they choose to do so. Typically, the banks have restructured their products and accounts in response, and introduced new computer-based technologies to offer corporations a package of cash management services that can handle not only currency, collections, and disbursements, but transactions in commercial paper, short-term notes, and foreign exchange.

For a multinational corporation (MNC), the cash management system will aggregate information from, and move funds among, branches

[3] J.M. Barry, "Computer Snarled N.Y. Bank," *Washington Post*, Dec. 13, 1S85, p. D1. Trading in government securities averages about $200 billion daily.

and subsidiaries around the world. In effect, the bank helps the corporate treasury operation improve its efficiency—for instance, by sweeping all idle cash into an investment account on a daily basis.[4] The bank gives up the use of the higher balances the corporation once maintained, but gets fees for the-new services it provides. The corporation gets an integrated package, without having to put the system together itself (although some do). Already, cash management systems may provide direct access to market quotations and execution of buy and sell orders. In principal, a company can centralize almost all its cash management functions at a single treasury work station (a computer terminal or PC). Thus far, perhaps a thousand treasury workstations have been installed worldwide—most of them in the United States; as experience accumulates, they will probably become much more popular.

MNCs and other large corporations deal with many banks, most or all of which must participate for a cash management system to function efficiently. The major U.S. commercial banks pioneered integrated cash management services, at home during the 1970s and internationally beginning in the early 1980s. Differences in tax laws and banking regulations, as well as restrictive telecommunications policies, have led to complications abroad, with many foreign banks reluctant to participate. At present, for example, Japan's Ministry of Finance permits a computer link between a corporation and a bank, but prohibits electronic funds transfers; the Ministry plans to remove this restriction once Japanese banks have become more competitive in cash management technologies. While the larger European banks have also begun to develop their own systems, their software remains far behind the best U.S. practice. A survey of 60 large multinational banks, with headquarters in Japan, North America, and Europe, revealed that many depend heavily on American cash management technology.[5]

[4]RJR Nabisco (formerly RJ Reynolds) says it saves $2o million annually through cash management techniques. For instance, the company can now match a need for Deutsche marks 6 months in the future to pay for German tobacco machinery with an expected inflow of marks from overseas subsidiaries. Previously, it would have purchased a forward contract from a bank to lock in the price of the machinery in dollars, See "How the Last Became First," *Euromoney*, February 1986, p. 39.

[5]"New Directions in European Cash Management, " Business International, 1985. While most banks in most countries, including the United States, had developed their own software, 16 of the 60 worldwide chose Chemical Bank's **BankLink**. Outside the United States, software from National Data Corp., also an American firm, was the second choice to **BankLink**. Of the four Japanese banks surveyed, none had developed their own software, all looking instead to U.S. suppliers.

The survey painted a similar picture for network services. GEISCO, a **General** Electric subsidiary, supplied VAN services to half the overseas banks, and more than half the American banks. Overseas, local post, telegraph, and telephone authorities (PTTs) were second to **GEISCO,** with other U.S. firms, such as ADP, also providing services both in the United States and abroad. Four U.S. banks maintained private networks, but only 2 of **34** foreign banks.

A survey of corporate treasurers internationally ranked Citibank at the top of commercial banks providing electronic cash management services, followed by three other U.S. banks—BankAmerica, Chase, and Chemical. See "Corporate Finance," *Euromoney*, March **1985**.

securities directly. Securitization refers to the growing tendency for those on both sides—funds seekers and investors—to choose securities, and for these securities to be traded in secondary markets. Banks can securitize existing loans by selling the right to collect the interest and principal. Individuals securitize when they purchase shares in a money market mutual fund as an alternative to demand deposits.

Securitization reduces the demand for traditional financial services, particularly by larger customers; a corporation that once borrowed from a bank may now issue commercial paper directly. And in some cases, the bank's intermediary role—bringing together investors and those looking for financing—declines, But in other cases, even with securitization the bank continues its traditional functions, particularly those of managing the sizes, risks, and maturity of assets and liabilities; financial intermediaries collect small deposits and make large loans (and use demand deposits to fund term loans), and substitute their own creditworthiness for that of the borrower.

INTERNATIONAL BANKING STRATEGIES

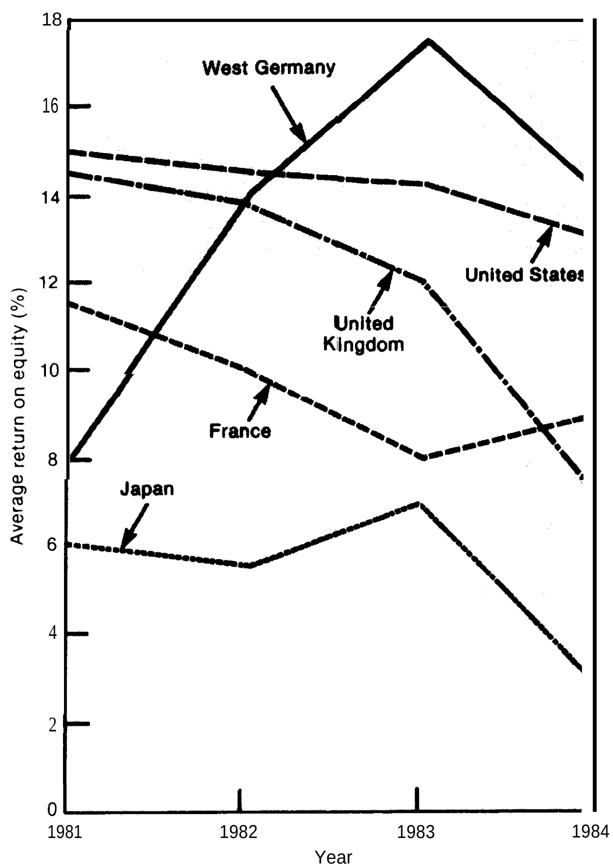
Profitability in banking has been dropping—figure 23.[9] While competition has intensified in lending, the traditional core of the business, loans have been diminishing relative to fee-earning services as a source of earnings. Regional and national markets, once comfortably segregated, have been opened to new entrants, domestic and foreign. Securitization has cut into customary sources of profit. With more intense competition, particularly in familiar lines of business, banks have searched for new strategies that might help them earn profits at accustomed levels.

Broadly speaking, deregulation has pushed financial institutions into riskier endeavors as they have sought to avoid the devolution of banking into a commodity-like service. They have developed new products, sought out new onshore and offshore markets, and, where possible, tried to move from commercial banking into related services—notably, securities trading and investment banking. In an industry like this, with many able competitors, competitive success normally comes through the accretion of small advantages. How well U.S. banks do in finding new and profitable markets will be perhaps the single most important factor in determining their future competitiveness. Regardless of whether the industry as a whole rises or falls relative to others in the world, some American banks will probably do quite well, and some might do quite poorly.

[9] No comparative data more recent than that in the figure is available. Both the largest and the smallest U.S. banks showed further drops in profits during 1985; although average profit levels for all U.S. banks rose in 1985, reversing a 5-year decline, Continental Illinois' return to profitability accounts for the entire gain. See D.J. Danker and M.L. McLaughlin, "Profitability of U.S.-Chartered Insured Commercial Banks, " *Federal Reserve Bulletin*, September 1986, p. 618.

Because of differing accounting rules, absolute values of return on equity across countries have little significance.

Figure 23.— Return on Equity in Banking, Five Countries



SOURCE *The Economist*, Mar 22, 1985

New and/or Rapidly Growing Product Markets

Banks that can identify and develop new products ahead of the competition can often generate relatively large returns, at least until their rivals catch up. Even then, product differentiation may offer continuing competitive advantages. Thus innovative financial products have been central elements in the strategies of American banks. Most of these products are not so much new ideas as existing products that have seen rapid growth because the combination of market conditions (inflation, exchange rate instability, deregulation, the Euromarkets, securitization—see box D inch. 2) and new technologies (computer networks, telecommunications) makes them attractive both for financial firms and their customers.

The pervasiveness of regulations complicates innovation in this industry. Government policies in both the United States and Japan, for instance, have restricted the spread of ATMs.

Photo credit Hong Kong Trade Development Council

Hong Kong's financial district

U.S. regulations generally allow withdrawals in two or more States, but deposit-taking across State boundaries has been limited by restrictions on both bank holding company activity and interstate banking. Japan permits ATM use only during certain hours, thus curbing one of their principal attractions—around-the-clock access. In both cases, regulations limit the advantages that innovating banks can expect.

Other innovations have come in direct response to regulation. In the 1970s, high U.S. interest rates, combined with regulatory limits on the interest banks could pay on deposits, led to the creation of money market mutual funds. Reserve requirements on deposits in the United States, and restrictions on capital movements here and elsewhere, contributed to the expansion of the Euromarket relative to more regulated capital markets during the 1970s and 1980s,

When new banking products circumvent existing regulations, national governments may respond by reinterpreting legislation or passing new laws. Alternatively, regulatory authorities may view the innovation as desirable, and perhaps liberalize the rules further. Internationally, deregulation has proved contagious: MNCs and other major bank customers can often choose the country and the banks—thus the regulations—they wish to deal with. National governments that fear the loss of valued customers then must liberalize their own regulatory structures. After fixed commissions were abolished on the New York stock exchange, trading volumes rose; the London exchange was eventually forced to follow suit. Liberalization of the London financial market, in turn, has brought in new business from Paris and elsewhere on the continent, with liberalization in many parts of Europe following.

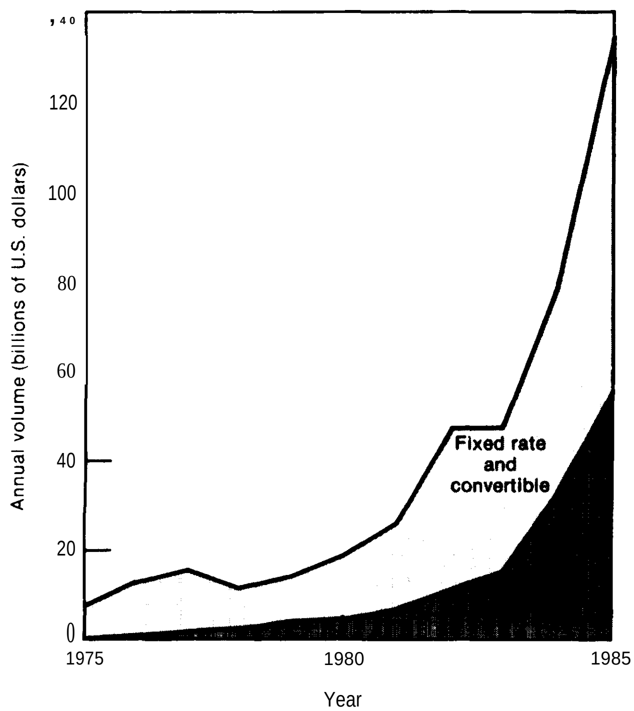
Deregulation has also spread to Japan. Until recently, Japanese corporations could not issue Euroyen bonds (bonds denominated in yen and sold in the Euromarket). Japanese corporations seeking to participate in the Euromarket were forced into other currencies, where Japanese banks tended to be less competitive. The government's decision to permit a Euroyen market (corporations still must meet certain financial tests) represents a concession to this reality. Still later, the authorities permitted an offshore market to develop in Japan (operations began in December 1986).

Eurobonds and Euronotes

Eurobond issues grew at about 30 percent per year between 1975 and 1985—figure 24. New Eurobond and Euronote issues totaled about $136 billion in 1985 and an estimated $180 billion in 1986.[10] Lack of regulation in the Euromarkets means lower issuing costs for the banks, and lower margins for customers. Customers as well as banks maybe able to bypass domestic constraints; South Korean firms, for instance, have sought medium-term financing in the Euromarket because inflation, uncertainty, and government restrictions have prevented the development of a medium-term domestic bond market in Korea,

Eurobonds come in three varieties: 1) traditional fixed rate bonds; 2) floating rate notes (FRNs–issued with maturities up to 7 years and paying interest at rates periodically adjusted to reflect prevailing short-term rates); and 3)

Figure 24.—Growth of the Eurobond Market



SOURCES *Euromoney*, various issues, "Recent Innovations in International Banking," Bank for International Settlements, Basel, Switzerland, April 1986, p. 163

convertible Eurobonds (which bear fixed rates but can be converted into equity shares of the issuing firm—in recent years these have never exceeded about 10 percent of the total market). As figure 24 indicates, new FRN issues have grown especially quickly; first marketed in 1978, by 1984 they accounted for 40 percent of the Eurobond market,

Table 13 shows that U.S. financial services firms have had by far the greatest share of the Eurobond issue market, doing even better in the rapidly growing FRN segment, American firms manage nearly 60 percent of issues denominated in dollars, and about two-thirds of all Eurobond issues for U.S. corporations, (Box H expands on the significance of the dollar as the primary currency of international trade,)

Trade Financing and Other Fee-Earning Services

One of the oldest international services provided by commercial banks, trade financing, continues to expand, Such traditional busi-

[10] "Key Figures, " *Euromoney*, February 1986, p. 170; "International Bonds: A Profitable Year for Borrowers, " *Financial Times*, Dec. 29, 1986, p. 13.

Shorter maturity bonds are known as notes.

Table 13.—Eurobond Issue Managers by Country

	Percentage share of new issues, 1984		
	Floating rate notes	Fixed rate notes	Overall
United States	53 0/0	35 "/0	440/0
Federal Republic of Germany	3	20	12
Switzerland	11	8	11
United Kingdom	13	6	10
France	11	4	8
Japan	2	10	8
Subtotal	93 0/0	830/o	93%
Others[a].	7 %	17 "/0	7%

[a]Includes smaller issue managers from countries listed, as well as countries not on the list

SOURCE *Euromoney* various issues

nesses as letters of credit (LCs), whereby banks endorse their customer's creditworthiness, are now carried out largely through the telecommunications infrastructure. Clients can request LCs electronically, using standard formats, with many of the communications handled via SWIFT or such U. S.-based data processing organizations as GEISCO and ADP. Paperwork costs have been cut, and the process is now much quicker—a matter of hours rather than weeks. (Citibank claims it can issue a letter of credit in a matter of minutes.) While the United States led in automating this process, some European banks, especially in Scandinavia, have developed competitive systems.

Box H.—The Role of the Dollar

Many of the world's financial transactions are denominated in U.S. dollars, even when the parties have no relationship to the United States. Trade between Japan and North Korea, for instance, has commonly been conducted in dollars. While the continuing importance of the dollar creates competitive advantages for U.S. banks, these advantages are small, and will no doubt decline further in the years ahead.

Why is the dollar so commonly used? Many of the reasons are historical. Before World War II, the British pound had been the world's primary currency for international transactions. But the major European currencies did not return to convertibility until 1957. The dollar has kept its role since, in part because the United States provides an unmatched banking infrastructure, with well-developed markets for holding short-term balances, in addition to political and economic stability. Moreover, the volume of international capital flows involving American companies, particularly during the 1950s and 1960s, also made it natural to continue using dollars. But decisions by residents of other countries to use the dollar—or any currency other than their own—depend on relative attractiveness, and most of these factors have less weight today than in earlier years. As market participants have diversified across currencies, the Deutsche mark (DM) and the yen have slowly gained in market share. Indeed, the yen has become almost as popular as the DM, one among many signs of the integration of Japan's financial system into the world system.

What advantages, if any, accrue to financial institutions doing business in their home currency? The first point is this: the more open and better developed the market, the less the advantages for domestic banks. Even in such countries as the United States, however, regulatory/administrative factors tend to tip the scales a bit. A second factor, related but distinct: domestic banks normally dominate the clearing (payment) system in their currency. Other banks bear costs (through their balances with members of the clearing system, as well as the fees they pay for services). For such reasons, domestic banks tend to have a competitive edge-small but potentially significant—in transactions involving their home currency. Even in the free-for-all external markets, U.S. ownership helps in attracting U.S. dollar deposits, while German bank branches do better in attracting DM deposits. With continuing deregulation, and movement toward globally integrated financial markets, such advantages will probably continue to erode. Even so, as pointed out at many places in this chapter, banking is a highly competitive business; a superior position must be built piece by piece, and each piece counts.

Standby letters *of credit* (SLCs) also substitute a bank's credit standing for that of the client. The market for SLCs—agreements to lend money should other prospective lenders refuse to do so—grew from almost nothing in the early 1970s to nearly $150 billion by 1984. Five large banks—Citicorp, Manufacturers Hanover, BankAmerica, Chemical, and Bankers Trust—account for more than a third of the U.S. total, Foreign banks, too, have been quite active in SLCs, with Barclays' New York branch reporting that in some months its letter of credit business exceeds its loans,

The fees a bank can charge for SLCs depend in part on market judgments of the bank's riskiness; if a bank has a high credit rating, its guarantee will be worth more. Because of their exposure in developing countries, U.S. banks have been viewed as relatively risky; many have been hard-pressed to compete with their Japanese and European counterparts. (Of the major U. S.-based banks, only Morgan Guaranty still has the coveted AAA rating.) Indeed, Japanese banks have recently backed tax-exempt State and municipal bonds in the United States, including issues by Michigan, and by the cities of Chicago and Philadelphia.

A *banker's acceptance* (BA) guarantees payment of a trade debt, These time drafts can be traded in a secondary market which, in the United States, amounts to about $80 billion annually. More than half of this represents third-country BAs, involving neither U.S. imports nor exports, The third-country portion of the market reflects, not only the prominence of the U.S. dollar in international trade, but the ability of U.S. financial institutions to capture business from banks in other nations also willing to deal in dollar obligations. Thus, the recent announcement by the Japanese Government that it will allow a yen-denominated acceptance market may or may not represent much of a threat to American banks. To the extent that the yen makes inroads on dollar-denominated BAs, banks based in Japan will have something of an advantage. Still, even in a yen acceptance market, U.S. banks might be able to remain competitive because of their accumulated experience.

Financial *swaps* enable two parties with advantages in different segments of the market to exchange (swap) their obligations. Banks earn fees for arranging these transactions—another example of the growing importance of non-interest income. New variations have fostered enormous growth in the market. Recently, much of the expansion has been in cross-currency interest rate swaps, For an example, consider that a Japanese firm seeks fixed rate financing in dollars, while an American company wants floating rate financing in yen. If the Japanese firm can borrow yen relatively cheaply, and the American firm dollars, they will be able to swap their interest rate obligations to their mutual benefit. The bank serving as intermediary absorbs the credit risk of each party. Many actual transactions become much more complicated than this example, involving three or more currencies and other complexities.[11] Because these transactions involve only a contingent liability on the part of the bank, they remain off the balance sheet, although some larger banks have begun to take swaps onto their books by offering a swap to one party even if no counter-party has yet been found.

U.S. commercial and investment banks have been leaders in the market for swaps, where success depends on efficiency, inventiveness, and quick response. Citicorp alone accounted for some $25 billion in swaps in 1985. Only one British investment bank (SG Warburg) and one French bank (Paribus) have established positions comparable to even the smaller U.S. players. Banks have developed the swap market largely in response to the needs of their clients. For commercial banks, these are mostly corporations. The leading investment banks—which include Salomon Brothers, First Boston, and Goldman Sachs—often arrange swaps for other financial institutions, especially savings and loan associations.

[11] In March 1986, American Express raised 20 billion yen in the Euroyen market, which it swapped into $109 million and then into securities denominated in eight different currencies, some of these securities at floating rates and some at fixed rates—L. Wayne, "New Broader Role for Finance Officers, " *New York Times*, Oct. 20, 1986, p. D6.

Many of the financial products discussed above--banker's acceptances, SLCs, swaps-share a common characteristic: they do not appear on the books of the bank, but the bank guarantees the credit of other parties. Regulators have been concerned over the growth of these possibly risky activities; governments require banks to maintain reserves of capital against their assets (mainly loans, but also treasury and other securities), in part to protect consumers and other depositors. To the extent that banks develop and market financial products without creating assets on their balance sheets, they avoid these requirements (and the associated costs). A bank that guarantees a loan may be able to collect a fee almost as large as the interest it could have earned if it had made the loan itself. Likewise for a swap, the bank guarantees payment of interest by both parties but neither of the swapped instruments becomes an asset or liability of the bank.

Regulatory authorities have looked askance at this de facto loosening in control. In most cases where governments have begun to count such items against capital requirements, they have viewed SLCs, swaps, and other guarantees as much smaller risks than loans. But the fact remains that, at this point, no one is in position to judge the real risks: growth in many of these markets has been very rapid; experience remains limited. In general, the United States has been slower than other industrialized countries to extend capital adequacy requirements to off-balance-sheet items. U.S. policy, therefore, seems to have had the effect of inducing American banks to market off-balance-sheet products more aggressively than their foreign competitors. So far, the result has been to help U.S. banks capture large shares of these markets,

Movement Into Investment Banking

Many commercial banks see attractive strategic opportunities in investment banking—trading in securities, underwriting stock and bond issues, arranging mergers and acquisitions. Investment banking holds out the prospect of recovering lost profitability: commercial banks do well to earn 15 percent on equity, while rates of return above 30 percent are far from unknown among investment banks (which do not take deposits or make loans). An American commercial bank contemplating a move into investment bank faces two sets of obstacles, the first legal and political, the second organizational.

The Glass-Steagall Act and other U.S. legislation bars firms from engaging in both commercial and investment banking in the United States (although American firms can do so overseas). While Japan maintains restrictions similar in some respects to those imposed in the United States, few other foreign governments maintain this regulatory separation; in countries including the Federal Republic of Germany, Switzerland, and the Netherlands, so-called universal banks underwrite corporate securities, offer mutual funds, and engage in the full range of stock brokerage activities. The freedom granted U.S. commercial banks to function as investment banks aboad has been one of the factors spurring expansion of the Euromarket (where, however, American investment banks have performed better than commercial banks in managing Eurobond issues, products similar to those investment banks work with at home).

In recent years, commercial banks have moved into new businesses domestically that test the limits drawn by U.S. law. Often, the courts have been asked to decide the merits of the arguments for a liberal interpretation of the restrictions, as put forward by commercial banks, versus the stricter standard suggested by investment banks. (The much smaller investment banks have not sought to move into commercial banking.) Two current examples:

1. Should Bankers Trust be permitted to broker commercial paper for its corporate clients? A Federal Appeals court in December 1986 ruled in favor of Bankers Trust, overturning a district court finding that had reversed a Federal Reserve decision. The Securities Industry Association quickly signaled its intent to appeal to the Supreme Court.

2. The Federal Reserve is expected to decide in 1987 whether commercial bank holding companies will be permitted limited underwriting of municipal revenue bonds and certain other securities.

As these examples suggest, and as discussed in more detail in the section on "Policy Issues" below, the separation of commercial and investment banking in the United States has been slowly breaking down, in part because new banking products blur some of the traditional distinctions, But if the erosion of Glass-Steagall and other restrictions continues, as it no doubt will, U.S. commercial banks face another obstacle in moving into investment banking—differences in organizational patterns and managerial style suggested by the saying that "bankers live off their assets, merchant bankers [i.e., investment bankers], live off their wits."[12] In the United States, managing a combined organization means reconciling such differences, a process that will take time and during which other opportunities might slip by. Plainly, greater freedom from legal restrictions would lead the larger commercial banks to venture further into investment banking. Some would probably be successful. Others might have trouble mastering new and unfamiliar lines of business, perhaps eventually withdrawing to more familiar territory.

[12] See P.L. Zweig, "Some Big Banks Find Entering New Fields A Tough Transition, " *Wall Street Journal,* Aug. 13, 1986, p. 1.

Unlike manufacturing companies, financial services firms depend on no raw materials or manufactured inputs to produce their end products. They do depend on people—the bank's employees. In international banking especially, the skills that employees bring to and develop on the job—and the ways in which the organization deploys these people and their skills—can make a great deal of difference for competitiveness. In this, banking is not unlike other knowledge-based service industries.

In recent years, banks have sought greater numbers of specialists in fields like bond trading, currency transactions, and swaps, Increasingly, they have hired in people from graduate schools of business to fill such positions, rather than promoting from lower positions within the bank–O. Bertrand and T. Noyelle, "Changing Technology, Skills and Skill Formation in French, German, Japanese, Swedish and U.S. Financial Service Firms: Preliminary Fin dings," report to the Center for Educational Research and Innovation of the Organization for Economic Cooperation and Development, August 1986, pp. 47-48.

Finding Profitable Market Segments in Commercial Banking

Onshore Retail Banking

Overseas retail banking has seemed a relatively conservative choice for banks seeking greater profits. Here, size by itself seldom provides much of an advantage, but new products, good service, and aggressive marketing hold out the promise of substantial rewards. Indeed, foreign banks have moved into the United States no doubt feeling they could offer better quality services and/or undercut their rivals' costs. The rapid spread of credit card services (e.g., Visa, Master Card), now offered around the world through joint ventures owned by participating banks, provides another example of international expansion in retail banking,

Particularly in countries with stable regulated markets, nominally competing banks have often been happy to fall into patterns of peaceful coexistence. When American banks have been able to enter such markets, their efficiency advantages have sometimes led to profit levels well above those of their local rivals.[13] On the other hand, U.S. banks have not done very well since being admitted to the Canadian market in 1980. Earlier government restrictions barred foreign banks from establishing subsidiaries, branches, or agencies in Canada, and limited them to a 10 percent holding in a chartered bank, The result was high prices and profits for Canadian banks.[14] Since 1980, foreign banks have been permitted to expand in Canada, but with restrictions—e.g., on the number of branches permitted—that continue to limit their ability to compete with Canadian banks; Citicorp, the largest foreign bank in Canada, has only eight branches. Foreign entrants have

[13] For example, Citibank has reportedly earned a substantial portion of its worldwide profits in Brazil—20 percent in 1982—where a grandfather exception permitted it to remain after the Brazilian market was closed to other foreign entrants. See I. Walter, "International Competitive Distortions in Banking and Financial Services," draft for Trade Policy Research Centre, London, March 1984, p. 112.

[14] After-tax return on capital to Canadian banks averaged 12.9 percent, compared to 9.1 percent for eight large New York banks—*Efficiency and Regulation: A Study of Deposit Institutions* (Ottawa: Economic Council of Canada, 1975].

been largely denied access to a low-cost deposit base; U.S. banks have not been able to earn the high profits that might be expected in a protected retail market. Nor is Canada the only country in which liberalization has been structured in such a way as to limit the opportunities available to U.S. and other foreign banks.

Citicorp, Chase, and a few British and Japanese banks have been the only entrants pursuing retail banking on anything approaching worldwide scale. Citi has major efforts underway in Europe and elsewhere, and has been quick to introduce new retail banking products in seeking greater market share. In Britain, Citi's more efficient systems help it process mortgage applications in 10 days, compared with a month for local competitors; Citibank claims to undercut the costs of its rivals by 50 percent in some lines of business .15 Other U.S. banks have been quite selective in entering retail markets abroad; Citicorp has been alone in expressing interest in acquiring a small Japanese bank as a wedge into Japan's retail market. Citi's strategy is predicated in part on technological superiority leading to lower costs. But to succeed in retail banking, a foreign entrant must also develop a detailed knowledge of local conditions–knowledge at least equal to that of the competition. This is a task that demands a strong commitment over time, even if the new entrant begins by buying an existing bank or hiring experienced people locally. Citicorp gets advantages from being a major commercial lender in many countries. This appears to be one reason it has been able to expand in overseas markets despite being perceived as a foreign presence—a far more serious disadvantage in retail than in commercial banking.

Commercial Lending to Small and Medium-Sized Firms

In recent years, banks both in the United States and overseas have been placing much more emphasis on lending to smaller companies (see, for example, the MetroBank case study in the appendix to ch. 8). Foreign banks in the United States lend to small businesses here; Citicorp's branches in many of the 90-some countries in which it operates are said to be eagerly pursuing the loan business of firms with sales in the $25 million and up range. The reasons begin with securitization, and the increasing self-sufficiency of large corporations. When these corporations go directly to the capital markets, banks may still provide guarantees, and sometimes distribution services, but margins tend to be thin. Smaller companies, less known and perceived to be more risky, still need the services of a bank to raise money,

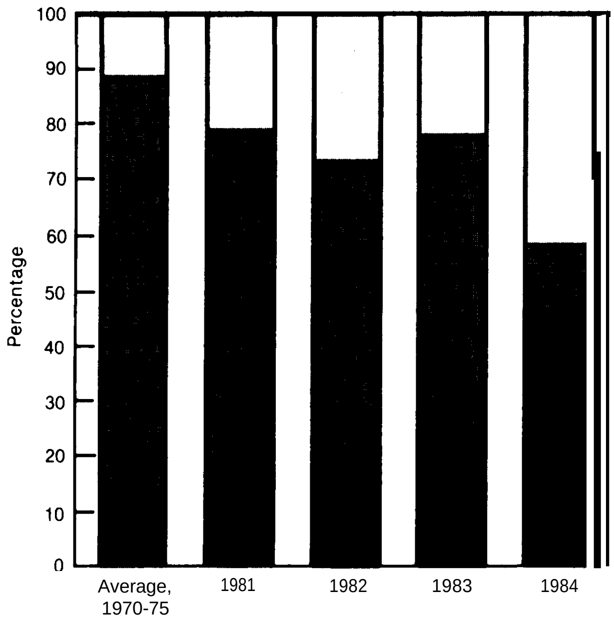
Financial institutions in different countries have developed this portion of the market differently. In Japan, businesses depended much more heavily on bank loans after the war than on equity, But by the 1970s, as Japanese economic growth continued, larger corporations could finance much of their expansion through reinvested earnings; Toyota, admittedly an extreme case, has generated so much cash the company has sometimes been called the Toyota Bank, As figure 25 shows, the drop in bank lending in Japan compared to other sources of corporate funds has been dramatic. Faced with rapidly declining demand for loans from their major customers, Japanese banks have sought to lend to the small businesses they once ignored.

The Future

Competitive strategy for any commercial bank seeking to expand internationally will hinge on its view of the coupling among its services. Will a bank that offers a broad range of products be able to reduce its costs? Will it reap marketing advantages, perhaps be able to lock-in its clients? Will a corporation that uses Morgan Guaranty as a lead manager in the Eurobond market also borrow money from Morgan domestically? If the answers to these questions turn out to be yes, then banks able to offer a comprehensive package of services will be well-positioned to grow and compete in international markets. By the same token, a bank with an extensive worldwide network of branches,

[15] "Citicorp's Gutsy Campaign to Conquer Europe," *Business Week*, July 15, 1985, p. 47. Also see P.L. Zweig, "The Elusive Consumer,'" *Wall Street Journal*, Sept. 29, 1986, p. 341). Citicorp has retail banking operations in 34 countries, Chase in 25.

Figure 25.—Sources of External Financing for Japanese Corporations



Equity issues ■ Bonds

Bank loans

SOURCE: "Survey of Japanese Financing and Banking, " *The Economist*, Dec 8, 1984, p 21

agencies, representative offices, and subsidiaries will be better placed to develop and market a wide range of financial products. On the other hand, no matter the efforts of banks to maintain ongoing "relationships" with clients, customers all over the world seem to be shopping for banking services more extensively than in earlier years. Relationship banking is in part simply a reaction to such trends, including securitization, While some U.S. banks will no doubt have success in locating profitable areas of foreign commercial banking, this is plainly not a strategic route open to all. Those that already have a broad and deep foreign presence —notably Citicorp—seem most likely to prosper through continued penetration of new onshore banking markets.

Furthermore, any strategy aimed at finding and exploiting unusually profitable lines of business depends on doing so before other financial institutions seize the same opportunity. Banking expertise is widespread, particularly in the OECD countries. The history of LDC lending demonstrates the point. Many regional U.S. banks, deciding there were profits to be made in loans to the developing world, set up offices overseas for the first time. Even without the Third World debt crisis, lower returns would have followed simply from the increase in competition. Lending to medium-sized businesses in Canada holds a similar lesson: after the market opened to American banks, fierce competition among Canadian, U. S., and other foreign banks kept profits low. While they lobbied hard and ultimately with some success for greater access to the Canadian market, American banks have been disappointed with the results. They have also won concessions from Japan's Ministry of Finance. This will enable U.S. banks to expand their activities in Japan, but here as well, competition promises to hold down profitability. The point is a general one: in an era of deregulation, profits will be low in many or most of the markets seen as new opportunities for American financial service firms,

Moreover, concessions overseas often go hand in hand with losses of previous advantages. Onshore foreign banks in Japan recently won the right to enter the trust business. The Japanese Government has granted licenses to six U.S. and three other foreign banks. These foreign banks now have a strategic option not open to the biggest Japanese banks. But other recent policy decisions—e. g., permitting Japanese corporations to issue Euroyen bonds—mean that, in at least some cases, Euroyen bonds placed by Japanese banks will supplant Eurodollar bonds that would otherwise have been handled by American banks.

Future competition in international banking promises to be fierce, with many entrants having similar capabilities seeking to establish themselves in new and growing markets (geographic as well as product), American banks do have sources of competitive advantage, primarily their experience in a deregulated and competitive environment, and in applications of technology. Foreign institutions have advantages of their own—e.g., the financial clout of the big Japanese banks—to set against them.

Photo credit: *Arthur Lavine Chase Manhattan* Bank N.A.

Currency trading room

JAPANESE COMPETITION: TWO SCENARIOS

Over the past decade, U.S.-based financial institutions have grown rapidly, In terms of assets, however, Japanese banks have grown much faster, as figure 20 showed, The astounding expansion of Japanese manufacturing industries has pulled Japan's financial institutions onto the world scene, with banks following their corporate customers abroad. Although banks from countries like Britain and West Germany are strong in some parts of the market, only the Japanese pose a real threat over the foreseeable future to the U.S. position in financial services.

This section sketches out two possible scenarios for the rivalry between U.S. and Japanese banks. In the first, regulatory constraints and other factors built into the Japanese system slow international expansion, blunting many of the competitive thrusts of Japan's banks. In the second scenario, more rapid deregulation by Japan's Government leads to concerted attacks on international markets by financial institutions largely free to pursue strategies of their own choosing, and with the financial muscle to succeed more often than not. On balance, OTA views the second scenario as more likely, but the critical decisions will be made within the Japanese Government, where they will emerge from the interplay of political and bureaucratic forces. Liberalization in Japan means still more intense competition in international banking, competition to which U.S. and Japanese banks bring differing sets of strengths. At the least, competitive life for U.S. firms will be more difficult.

Constrained Growth

Japan's large continuing current account surpluses have been accompanied by rapid growth in international assets, both financial and nonfinancial. Management of these assets has become the responsibility of Japanese financial institutions, especially the banks, which have grown proportionately. But despite their size, the sense has remained, in some circles, that Japanese banks, while undeniabably major players, have not yet become fully competitive with European and American banks internationally. Some of their rivals do not perceive the Japanese to be good bankers, claiming that they lack the skills and experience that are the strengths of U.S. and European financial firms. Japanese banks, for instance, must compete for the best graduates of the best universities with other industries and with government ministries—a sharp contrast with the United States, where investment banks, especially, can often pick and choose, competing only with one another. All this could change, but in the constrained growth scenario the change will come slowly.

Japan also has a currency that has not been widely used to denominate international transactions. The dollar remains the currency of choice in offshore financial markets, and, to a lesser degree, in trade (box H). To the extent that these patterns continue, American financial services companies have a source of ongoing if modest advantage, while Japanese banks face a competitive hurdle. The Japanese, of course, understand this. Why have they not taken steps to make the yen more acceptable in international business circles? That is, given Japan's presence in world commerce, why hasn't the Euroyen market developed faster? Only in 1986–although the relative asset growth of Japan's banks has been visible for years—did the Ministry of Finance (MOF) permit an offshore Euroyen market in Tokyo.

The reluctance of Japan's Government is understandable. An open door for Japanese financial institutions to participate in international markets, and for the yen to become more widely used, necessarily implies opening Japan's domestic financial markets to foreigners. Indeed, this move would have to come first. For the yen to be a major currency internationally, both foreigners and Japanese must have greater freedom to move funds into and out of Japan, to maintain accounts of all kinds, and to otherwise enter Japanese financial markets—as has been the case in dollars in the United States for years.

The MOF, one of the most powerful agencies in the Japanese Government, although slowly loosening its grip on financial and monetary affairs, has no wish (at least in this scenario) to take liberalization nearly as far as it has gone in the United States. Japanese officials view "guidance" of the banking system as one of the critical elements in their country's postwar economic boom. With the postal savings system an important source of financing for Japan's budget deficits and outstanding debt—at interest rates low by world standards—the MOF has little enthusiasm for liberalization, which would raise the cost of servicing that debt. Furthermore, a wholesale loosening would make domestic monetary policy more difficult to implement, and leave the Japanese economy more vulnerable to ill-conceived monetary and fiscal policies elsewhere in the world—a decidedly unpleasant prospect to MOF officials.

Large Japanese corporations see things differently. Regardless of their view of the past, today most would argue that the closed nature of Japanese financial markets limits their strategic opportunities and competitive prospects. Corporations want to control their own financing, without interference from the government. The constrained growth scenario, therefore, hinges on the MOF surrendering its authority only grudgingly, and more often than not prevailing over corporate interests and other government agencies—e. g., the Ministry of International Trade and Industry—that favor liberalization.

Indeed, the MOF appears to be split internally on this issue, with some factions advocating more rapid change. But the interplay of forces within the Japanese Government, and the policies that emerge, will tell only part of the story. Even assuming more freedom for Japan's banks, will they be able to increase their competitive presence as rapidly as Japanese manufacturing firms? Analogies do exist between Japan's growing competitiveness in financial services and past successes in manufacturing. But none of the analogies is particularly close. The constrained growth scenario treats the competitive precedents with skepticism, emphasizing the differences between financial services and the typical Japanese strategy in manufacturing (build scale at home; find attractive market niches overseas; export from a secure base in Japan, seeking greater market share; invest in foreign markets only when forced by political pressures and the threat of trade barriers).

In the constrained growth scenario, two key differences weaken the parallels with Japan's past competitive successes. First, U.S. banks will not easily be outflanked. These are not steel companies, domestically oriented and comfortably ensconced behind barriers created by transportation costs thought high enough to keep out foreign products. Nor automakers, with an international perspective and many foreign investments, but with domestic products perceived as uniquely suited to U.S. market conditions. Nor even computer companies, with technological leads that shrank much faster than expected.

Banking was an international business before Columbus; Japanese banks have been participants for more than a hundred years. For several decades, American financial firms have won out in world markets against able foreign competitors through aggressive strategies and innovative products. Moreover, American banks compete strongly among themselves. Those that survive domestic competition are well-placed to compete internationally. Even more, an increasingly permissive U.S. regulatory environment has taught them how to maintain high levels of customer satisfaction without compromising efficiency, Finally, the U.S. industry benefits from a home market that is the center for new applications of computer hardware and software technologies, as well as telecommunications. Thus, to successfully attack the U.S. banking industry, any competitor must put together a coordinated strategy that can be effective on multiple dimensions (e.g., offshore markets, business lending, retail banking, investment and brokerage activities, applications of new technology). Those accepting the constrained growth scenario see little indication that the Japanese (or anyone else) have the capabilities to succeed in such an endeavor,

There is a second difference. The structure of this industry differs markedly from manufacturing sectors, where Japanese companies could begin by creating efficient production systems to supply domestic markets. When they identified market niches abroad—e. g., small, black-and-white televisions—Japanese firms could export and sell at low prices, taking advantage of their domestic base and local labor force. This is decidedly not the case in a service like banking. To compete, Japanese financial firms must maintain operations in world banking centers such as London and New York, They have to rely on the same labor pool and confront the same cultural traditions as others. They cannot depend on their strength at home, but will have to develop competitive advantages in markets not only far away, but in the backyards of their strongest competitors, This is a new and different competitive environment for the Japanese, one in which success promises to be elusive.

For all of these reasons, then, in the constrained growth scenario, Japanese competition will be slow to develop. Competitive thrusts by Japanese banks will be isolated, with little cumulative effect. U.S. financial service firms will maintain their international leads. The MOF, a conservative force within the Japanese bureaucracy, will not abandon the tools that it believes responsible for a favorable macroeconomic environment. Japanese financial markets will open only slowly. Meanwhile, the U.S. regulatory climate will remain conducive to American success.

Rapidly Mounting Competitiveness

What would it take to invert the picture above? More than anything else, ways in which Japan's banks could turn the enormous increase in Japanese-held financial assets to competitive advantage. Although this overseas asset growth cannot be attributed solely to the efforts of Japanese banks, the fact is that the assets are there, and Japanese banks (and others) have the opportunities (or problems) of managing them.

Not only have the largest Japanese banks grown bigger, more Japanese banks are now powerful enough to be serious players internationally; by some measures, Daiwa, ninth among Japanese banks, is larger than Chase. With expansion come new sources of competitive advantage: Japanese banks can pursue more strategies simultaneously, undertake more activities independently, without the need for correspondent banks or syndicates. Moreover, their asset holdings will continue to grow, at least for the next several years, Although Japan's exports have slowed somewhat, her trade surplus remains large; Japanese financial claims on the world will continue to mount.

Thus far, however, the Japanese approach to their overseas assets has been a conservative one, emphasizing safety. Funds have been held in foreign bank deposits, or invested in Treasury bills and notes, denominated in local currencies. While prudent, such strategies sacrifice many opportunities for greater earnings, A number of signs now point to a more active posture by the Japanese.

Almost any scenario that sees a rapidly expanding Japanese presence in international banking must begin with foreign direct investment in manufacturing. For 30 years, Japanese manufacturers have been very aggressive in seeking out export markets and in guaranteeing their supplies of raw materials (e. g., iron ore) and energy (coal and petroleum). Until recently, most of their other international ventures have been tentative and small in scale. Japanese investments in Western Europe remain a small fraction of U.S. investments there (a cumulative $11 billion, versus $107 billion for the United States)," Until the last few years, both business and government in Japan have directed their attention to internal development; electronics and automobile firms, for example, began building plants in the United States only after trade-related political pressures built to very high levels.

Now, of course, the picture is changing rapidly. As pointed out in the preceding chapter, Japanese manufacturing firms have stepped up their foreign investments and begun to establish truly multinational operations. In this, they are following in the footsteps of American firms—footsteps 30 or 40 years old. Just as American firms invested in Europe to assure continued access to markets there, Japanese companies now find themselves seeking to avoid incipient trade restrictions in both Europe and the United States. And, again like American firms before them, Japanese companies now see stronger ties with their foreign customers as a competitive necessity.

Expansion abroad has inescapable consequences for the Japanese financial system, and for the government. Historical parallels suggest that Japanese banks will seek to expand overseas, following on the heels of manufacturing investments. U.S. banks moved abroad to service customers setting up offices and factories around the world. American companies preferred, and still prefer–all else equal–to deal with American financial institutions. But if the banks do not offer their services overseas, companies will find alternatives in foreign banking industries, American banks had little choice but to follow their customers. Japanese banks have the same choice–or lack of choice. They, too, will follow their customers into foreign markets.

But providing familiar services to familiar customers in a foreign setting does not make an international bank, or an international in-

[16] "Japanese Investment in Europe, " *Financial Times, Nov.* 13, 1986, sec. 111. Department of Commerce estimates placed U.S. foreign direct investment at 41 percent of the world total in 1981, compared to 7 percent for Japan. *International Direct Investment: Global Trends and the U.S. Role* [Washington, DC: Department of Commerce, 1984), p. 45.

dustry; much more is necessary, beginning with accommodating government policies in both home and host countries. In general, favorable host country policies already exist. Japanese manufacturers are moving into markets where other foreign firms—financial firms included—have been comfortable for years. Japanese Government policies, as discussed above, seem a different matter. Indeed, the future policies of the MOF and other Japanese agencies will be perhaps the single most critical factor in determining rates of international expansion by Japanese banks.

With trade friction and political pressure mounting on many fronts, financial liberalization is but one of a series of policy questions facing Japan's Government. For years, other countries have objected to export-led growth in Japan, and demanded reciprocal access to markets there. Beyond this, other countries have begun pressing the Japanese to behave more like a major world power. Japan's corporations, meanwhile, face stronger competition in their traditional export markets from developing countries—South Korea, Taiwan, even Brazil. With Japanese manufacturers responding to new pressures in part through rapid increases in foreign investment, financial institutions, by every indication, wish to become more active not just in financing for Japanese corporations, but in the entire range of banking services supplied internationally. Both manufacturing and banking sectors will press their views on the Japanese Government—arguing that financial liberalization is necessary, and must come quickly. The real questions, then, concern the government's response.

As yet, the MOF has not been willing to move very far on domestic matters—a precondition for international expansion, for reasons outlined above. Still, many signs in both official reports and in the Japanese press indicate that the Ministry will not try to stall liberalization indefinitely. MOF officials, like their counterparts elsewhere in the government, have many times acknowledged—to be sure, in vague and noncommittal ways—the need for Japan to take its rightful place among the world's economic powers.[17] Given changing attitudes elsewhere in Japan's Government (and in some parts of the MOF), it is a reasonable presumption that, although the Ministry may be able to fight *a* rear guard action, ultimately it will have to give way. In this second scenario, the MOF gives way sooner rather than later.

The major Japanese banks, foreseeing the eventual outcome on the policy front, clearly plan to be ready; they are attempting to gain experience, as quickly as possible, in the somewhat arcane ways of international banking. They still have a good deal to learn. Will Japanese banks be able to establish foreign branches and subsidiaries that can compete head-to-head with long-established and aggressive rivals? On such matters, the jury will be out for a number of years. But few today would underestimate the ability of Japanese firms in *any* industry to master the intricacies of international competition. And of course, the banks will not be alone. With the new foreign investments by Japanese manufacturing firms, Japanese financial institutions have a ready-made customer base, solid ground on which to build.

This leaves, finally, the question of whether the world will continue to rely on the U.S. dollar, The answer, in this scenario, is that it makes little real difference. The primacy of the dollar is not all that important for American financial firms. Non-U.S. banks compete effectively in offshore dollar markets already. Indeed, banks from quite a large number of countries compete successfully in whatever markets they choose to enter, even if they cannot manage a presence across the board. Beyond this, the dollar will not necessarily retain its dominance over the longer run. Other currencies—notably the yen—could make inroads. This would, once again, require policy changes in Japan, but Japanese economic strength makes growing prominence for the yen inevitable.

[17]Fo r example, "International Banking's Pending Issues Suddenly Unfold *Japan Report,* Joint Publications Research Service]PRS-JAR-86-018, Dec.19, 1986, p. 58—an interview with Takotomo Otsu, International Finance Bureau, Ministry of Financ e, translated from *Ginko Jihyo*, Sept. 16, 1986,

In this scenario, then, Japanese competitiveness in international financial markets steadily increases. Japan's Government raises its profile internationally, making clear its intent to protect the interests of Japanese banks should an international debt crisis arise. Major U.S. banks, vulnerable because of their exposures in the developing world, find the competitive balance tilting toward the largest holders of international deposits in the world.

It is too early to predict outcomes. But competition between the United States and Japan in financial services will certainly intensify. The competition will differ in many ways from that in manufacturing industries, but past experience suggests that it would be better for U.S. bankers and U.S. policy makers to err on the side of overestimating rather than underestimating the Japanese threat. Policy makers in the U.S. Government tempted to urge their Japanese counterparts to liberalize rapidly might first think through the full range of possible consequences,

POLICY ISSUES

Governments everywhere regulate banking; in some places they own the banks. Rules set by governments determine the products offered, and, indirectly, the profits that are possible. Banking is a very special industry. Banks provide the mechanisms for creating, transferring, and storing money—essential for the exchange of goods and services. All industrial market economies have relatively complex and sophisticated banking systems. Banks are also special because of their role as depositories of savings and other financial assets. All governments take steps to protect consumer deposits, Finally, governments implement monetary policy through the banking system—in the United States, a process centering on the Federal Reserve Board (FRB), The special nature of banking means deregulation—permitting banks and bank-like firms to respond more directly to market incentives—will not go too far. Deregulation tempts banks into riskier lines of business. But customer safety, and public perceptions of safety, will keep governments involved in the banking industry, just as governments will continue to regulate some aspects of the airline industry.

Given the special relationship between government and the banking system, should Federal agencies support U.S. banks internationally? If so, when and how? Or should the primary concern of policy makers be domestic financial services? In reality, such distinctions are false. As the scenarios for Japanese competition suggested, competitive ability depends in part on domestic policies—a fact of life in this and many other industries, although one that the U.S. Government has seldom acted on, or even acknowledged,

Domestic Regulations

Separation of Commercial and Investment Banking

Although administrative and judicial decisions have widened the scope of activities permitted commercial banks, and the bank-like businesses that compete with them, the Glass-Steagall Act and other U.S. laws and regulations continue to enforce a separation between investment and commercial banking. Few other countries divorce these two activities.

The argument for following much of the rest of world in permitting universal banking begins with the steadily increasing integration of national capital markets, and the growth of hybrid products such as floating rate notes that combine features of commercial and investment banking services. With securitization, investment banking products tend to replace commercial banking products, To be competitive in investment banking, moreover, now demands large amounts of capital–capital that U.S. commercial banks have, and U.S. investment banks need, Mergers and acquisitions involving U.S. investment banks—including the recent purchase by Sumitomo of a share in Goldman

Sachs—have been driven by these requirements for capital. Finally, say the advocates of relaxation, the view that combining commercial and investment banking leads to potential conflicts of interest—the original reasoning behind Glass-Steagall—is no longer true, if it ever was (as shown in part by the lack of such problems in universal banking in Europe).[18]

The case for maintaining the separation with little or no change rests on a different logic. Removing the restrictions would work to the benefit of large commercial banks–many of which have made major errors in judgment in recent years. The implication? Relaxing Glass-Steagall and other restrictive policies might simply give big banks more room to make big mistakes, perhaps requiring new government interventions to resolve.

Whether one likes it or not, however, the walls between commercial and investment banking are crumbling. policy makers must first ask, given continuing efforts by commercial banks to expand into these activities, whether it will be possible to continue enforcing the separation indefinitely. After all, commercial banks seek to move into investment banking in part to counter the thrusts of other financial and non-financial firms into their own territory—thrusts made possible by deregulation in the United States over the past decade.

In a climate of contagious deregulation, can the barriers between commercial and investment banking hold? OTA's analysis suggests that, in the long run, they cannot. The analysis also suggests that the regulatory separation has had only limited significance for the international competitiveness of the U.S. financial services industry (helping in some ways, hurting in others)—but that a policy of attempting to preserve the separation indefinitely could be inefficient if not counterproductive.

U.S. banks will continue expending effort and resources in finding ways to circumvent the rules—effort that might better be directed elsewhere. The questions then become: When and how should the rules be relaxed? Should policymakers permit gradual and selective entry by commercial banks into some but not all currently prohibited businesses? Or should the prohibitions simply be dropped at some agreed time? It may be time for Congress to confront these issues more directly.

Regulation of Interstate Banking

The other major division imposed on the banking industry by U.S. legislation, in the form of the McFadden Act, together with subsequent laws restricting bank holding companies, has been geographic: banks were not to expand across State lines. Here, judicial rulings, legislative changes, and technological developments have combined to undermine many of the prohibitions written into the law, as these affect wholesale and international banking,

Indeed, at this point, permitting unlimited interstate banking would make little difference for the international postures of U.S. banks, with one exception. In several parts of the United States, existing small to medium-sized banks have begun to merge into super-regional firms—often taking advantage of legal provisions that favor their expansion over existing money-center banks, Although few do much overseas business currently, some will probably grow large enough to support operations in, say, London—in doing so, recapturing customers lost to correspondent and money-center banks. (NCNB, of North Carolina, is one of only six U.S. banks with membership on the London Stock Exchange.)

While the emergence of these super-regional banks will take time, they could eventually provide a source of new vitality, helping the U.S. industry maintain its competitive position, In sum, there seems little reason based on *international* considerations for Congress to consider changes in the laws governing interstate banking.

The Banking Infrastructure

The FRB, along with agencies such as the FDIC, maintains a dual relationship with the

[18] For the historical background, see I. Walter, *Barriers to Trade in Banking and Financial Services* (London Trade Policy Research Centre, 1985).

U.S. banking system. On the one hand, as a regulator, the Board sets rules under which banks must operate. On the other hand, the FRB also supplies banking services—notably clearing and settlement for member banks, a critical part of the Nation's banking infrastructure. How well government agencies fulfill their functions as intrinsic parts of the banking system helps to determine the competitive position of the U.S. industry.

When a Korean firm borrows dollars, the transfer of funds from the lender's account to that of the borrower normally takes place through the CHIPS system, while the net settlement between banks involves FedWire (box G). FedWire, CHIPS, and the other elements in an efficient transfer system have played key roles in maintaining the dominant position of the dollar in world commerce. By legislation, the FRB's FedWire system is to be a break-even service.[19] In recent years, the Board, in its role as regulator and provider of net settlement services, has acted in ways that insulate FedWire from competition. For instance, the Fed has imposed caps on daylight overdrafts regardless of whether the overdrafts are on FedWire or a competing service. Banks, needing to carefully monitor their overdrafts, have tended to give more of their business to FedWire, at the expense of private competitors.[20] Fewer rivals for FedWire could mean less pressure to keep prices low and reliability high—the principal issue for policy makers.

The possibility of conflicts between the Fed's concern for its own profitability and its regulatory responsibilities will exist so long as the FRB acts both as competitor and regulator; given the importance of FedWire and other portions of the banking infrastructure for the Nation's competitive position, maintaining the efficiency of this infrastructure becomes an ongoing policy issue of some significance. If anything, the Monetary Control Act of 1980, which requires the Fed to cover its costs, may encourage the Board to use its regulatory power to reduce competition, and, with it, the efficiency of the payments process.

Safety and Stability of the Financial System

Like the Fed, the FDIC provides services to the U.S. banking industry—deposit insurance, for which banks pay an annual premium—while also functioning as a regulatory body. In practice, the FDIC may act to protect all deposits, even those in overseas branches, given its overriding concern with preventing bank failures in the first place. The FDIC's policy of protecting banks in order to protect depositors means that new financial products may, like overseas deposits, get the benefits of the FDIC umbrella even though in principle outside its coverage (and even though no premiums are paid). Standby letters of credit, for example, create contingent liabilities for the bank. If the borrower fails, the liability becomes a real one. A deposit insurance program that prevents bank failures has the effect of insuring SLCs as well, even though the FDIC's legal obligations may not extend this far (a question at present unanswered).

SLCs are only one of many examples where the FDIC's nominally domestic guarantees can affect international competition. But it would be wrong to suggest that FDIC protection creates major competitive advantages for U. S.-owned banks. Other industrialized countries are no more likely to let their large banks fail than is the United States. The issues revolve around the implicit subsidies provided by such guarantees.

Governments everywhere stand behind their financial systems. In doing so, they help their banks compete. Unless governments collect fees or premiums reflecting the risk of failure, they are subsidizing these banks. Subsidies may well be justified, considering the benefits to the public at large, but they nonetheless raise the question of distortions internationally. Movement toward standardizing practices across countries—e. g., tying premiums to the protec-

[19] In 1984, the Board reported that FedWire had become largely self-supporting, and that its wire transfer services as a whole had made a $3.5 million profit. *Seventy-first Annual Report, Board of Go vernors of the Federal Reserve Board* (Washington, DC: Federal Reserve Board, 1985], p. 194.

[20] See J.W. H. Watson, "Fed Drives Out Competitors in Bank Fund Transfers," *Wall Street Journal*, Mar, 13,1986, p. 30. Bankwire, founded in 1952, and by 1971 jointly owned by some 200 U.S. banks, ceased operations in Febuary 1986.

tion actually provided, thus reducing subsidy levels, or reducing uncertainty as to the immediacy of payment in the event of a failure—would be a significant step toward a level playing field. Another step would be to pursue international agreements aimed at coordinating regulatory and supervisory practices, thereby reducing the need for either implicit or explicit insurance. Put another way, international coordination of regulatory practices can reduce the potential for distortions in financial markets. International agreements aimed at standardizing such practices, although they might take years to achieve, merit high priority as a U.S. negotiating objective (see below and also ch. 10).

Problem loans to developing countries raise similar issues. Some of these loans pose potential threats to the solvency of large U.S. banks. How far should the Federal Government go toward lessening these threats? The Baker Plan—a U.S. initiative proposed by Treasury Secretary James Baker, calling for joint action by the banks, the borrowing countries, and multinational lending institutions (e.g., the World Bank) —would help the borrowing countries service their debt, thereby reducing risks for the banks, But perhaps more effective government policies could have kept the banks out of the trouble they're now in. LDC loans also raise the question of coordinating policies toward loss reserve requirements—currently stricter in the United States than in Japan, for example.

Given the trends outlined in this chapter, policymakers may wish to consider risk-related insurance premiums as an alternative to other forms of regulatory interventions in the financial services industry. The Third World debt situation provides perhaps the strongest argument for such an approach, The problem, of course, lies in making the judgments about riskiness, particularly for new or different ventures. Still, that is what insurance is all about.

Does the United States Need a New Approach to Banking Regulations?

The U.S. deposit insurance system, the regulatory separation between investment and commercial banking, and restrictions on interstate banking all stem from legislation passed in the aftermath of the banking collapse of the 1930s. The laws have been modified over the years, but with no fundamental shift in philosophy. In the practice of banking, however, change has been sweeping—both internationally and domestically (e. g., the rise of non-bank banks). Perhaps it is time for Congress to consider comprehensive new banking legislation,

Reasons for considering a new approach begin with interactions between spheres of regulatory and supervisory practice once largely independent, but no longer so. For example, lifting the Glass-Steagall restrictions would force changes in FDIC insurance; otherwise, the insurance umbrella would, in effect, be stretched over a wide range of risky activities for which it was never intended. Banks with FDIC coverage would be competing with uninsured non-banks, who could legitimately protest unfair competition. One alternative would be to switch the basis for regulation from an institutional focus (i. e., regulating what a particular type of institution can do) to functional regulation. Commercial banks might then be permitted activities currently denied them under Glass-Steagall (and other current laws), but in turn directed to treat funds from different sources differently. For example, individual depositors could be protected by requiring banks (and non-banks) to invest funds from small depositors only in short-term Treasury securities, and to give such depositors priority in the event of a voluntary or involuntary liquidation—thereby reducing or eliminating the need for insurance to protect consumers,

Future Policies; Negotiating Objectives

Data for Analysis

The Federal Government collects a great deal of data on international banking compared with other service industries; unfortunately, none of it measures international banking activity in ways that correspond to exports and imports in other industries. [21] Because existing data can

[21] *Trade in Services: Exports and Foreign Revenues* (Washington, DC: Office of Technology Assessment, September 1986). The

offer little guidance for policy makers on probable consequences of changes in either foreign or domestic policies, banking and other financial services deserve high priority in any effort to improve data collection and analysis relating to trade in services. In the absence of such information, policy makers might, in fact, wish to reemphasize liberalization of trade in financial services simply because the consequences for the U.S. economy cannot be predicted.

Dealing With Restrictions Abroad

U.S. financial services firms face severe restrictions in many foreign countries .22 Some governments simply deny entry to foreign banks, or limit the businesses they can pursue; until recently, Sweden prohibited any foreign bank office from accepting deposits or making loans. Some countries deny foreign-owned banks full access to the central bank discount window; foreign banks must often use clearing systems controlled by their local competitors.

There are cases in which U.S. banks can engage in activities denied to local banks. Until the early 1980s, only foreign banks in Japan could make foreign currency loans to Japanese borrowers—a lucrative business. Opening the market to Japanese banks has hurt the onshore firms, But in general, foreign government policies limit U.S. banks compared to their local rivals, with restrictions on the type of foreign presence—branches, subsidiaries, agencies—making it difficult for U.S. banks to operate as integrated multinationals. Australia, Canada, Finland, New Zealand, Norway, and Sweden, among others, permit foreign banks to establish subsidiaries but not branches. This imposes more of an arms-length relationship than other organizational forms. Some countries limit transfers of funds across their borders. Negotiations that would help American banks integrate their worldwide operations deserve high priority,

Unfortunately, the 1978 International Banking Act removes a potential lever for U.S. negotiators. So long as the law is in place, the United States cannot really threaten to reciprocate when other countries place burdensome restrictions on U.S.-owned institutions, A credible threat of reciprocity in banking regulations, even if never called upon in practice, could be a negotiating advantage for the United States. Congress may wish to consider amending the International Banking Act to this effect.

International Coordination

Each country has its own banking regulations, with many differences. South Korean companies seeking to expand have a difficult time raising money in part because of restrictions on Korean banks. And if a Korean bank tries to float bonds in the United States for a Korean corporation, it will face restrictions that limit the foreign portfolio holdings of American purchasers. For such reasons, the Korean company will more than likely go to the Euromarket, where neither Korean nor U.S. regulations apply. Similarly, a multinational corporation will do business with banks wherever it can make the best deal. U, S.-based MNCs will borrow from European or Japanese banks if lower capital ratio requirements permit better terms than American banks can offer. European banks and governments, meanwhile, argue that their tighter supervision of off-balance-sheet activities handicaps them unfairly in markets for, say, floating rate notes.

The dilemma is plain. Asymmetries in regulations induce banks to move their operations elsewhere—e.g., to offshore markets. If national governments maintain their regulations unchanged, their domestic banking industries lose business and their regulatory agencies lose con-

(continued from previous page)
special problems posed by measuring trade in financial services are summarized on p. 40, with OTA's own estimates for foreign revenues in commercial banking on pp. 56-58. These estimates suggest that the foreign revenues (not exports) of U.S. banks probably exceeded $12 billion in 1984, but the underlying data are too weak to place a great deal of confidence in this or any figure.

[22] For details, see "National Treatment Study: Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations, 1986 Update," Department of the Treasury, Washington, DC, December 1986. Also: earlier Treasury Department national treatment studies (in 1979 and 1984); *International Trade in Services: Banking* (Paris: Organization for Economic Cooperation and Development, 1984]; and "Direct Sources of Competitiveness in Banking Services" prepared for OTA by J.G. Kallberg and A. Saunders under contract No. 533-5640, pp. 5.5-5.47.

trol. They can either try to extend their regulatory grasp to the offshore market or liberalize domestically. Offshore markets cannot be unilaterally regulated, but U.S. policy makers have nonetheless sought at times to have it both ways. The FRB's decision in 1981 to permit U.S. and foreign banks to establish international banking facilities (IBFs) in the United States represents an attempt to compete with offshore markets by permitting lightly regulated Eurodollar-like markets here. But in part because IBFs still must live with more regulations than competing offshore establishments, growth has been slow. Attracting more of this business to the United States would mean relaxing regulations that the FRB considers important for the stability of the U.S. banking system.

Where banks and their customers meet in international capital markets, then, banks will press their governments for treatment at least as lenient as their foreign rivals, or seek agreements that will impose tighter standards on those rivals. U.S. banks argue for higher capital ratios elsewhere or lower ones in the United States. But the function of such regulations is to preserve stability—an objective difficult to question so long as regulations do not unnecessarily sap efficiency, All this suggests that, difficult as it maybe to achieve, international coordination of policies toward banking should be a paramount goal—that this is one industry where the hoary notion of a level playing field has real meaning as a policy objective; there is no reason to permit large financial institutions or large MNCs to play off governments—each with good reasons for regulating financial services—against one another.

U.S. policy makers will need to continue balancing the need for safety and stability in the Nation's banking system—and the ability to pursue monetary policy—against the benefits of a more liberal and presumably more efficient banking system worldwide. Policy makers may also find it time to begin considering whether to move beyond coordinated national policies toward supranational supervision and regulation of financial services.

CONCLUDING REMARKS

International banking has grown very rapidly in the postwar period. U.S. financial services firms have been pre-eminent over much of this time, although banks from other countries have often grown faster. These strides by foreign banks do not mean that the competitive abilities of American financial institutions have diminished so much as that other economies have been expanding rapidly, and their banking industries becoming stronger.

Banks compete not only with one another, but with their customers. Businesses turn to banks for financing needs ranging from cash management and short-term revolving credit to the structuring of complex financial packages for capital expansion and overseas investment, Large corporations need financial institutions relatively less than smaller companies. Multinationals have the capability to manage their own cash and market their own commercial paper, although they may need banks for access to the clearing system or for insuring their paper. As a corporation's own cash management system improves, its banks must maintain an edge or lose business; if the banks get better, the corporate treasury operation will too.

Electronic cash management is possible only because of developments in computer and communications systems; data processing and telecommunications technologies help integrate world capital markets, make new banking products possible, and provide faster and cheaper delivery of traditional banking services. As electronic messages have replaced paper and the telephone, the amount of *informat*ion available to bankers making decisions on loans or currency transactions has increased enormously.

Innovations in financial products and in the technology for delivering services have helped American banks maintain their competitive positions. U.S.-based institutions have dominated in markets for new products such as interest rate swaps and Eurobonds. They have adapted rapidly to securitization; when it comes to technologies used in trading securities, American firms lead the rest of the world by substantial margins. In many markets, U.S. banks have been successful despite inherent disadvantages; examples include banker's acceptances for third-party trade, and securities underwriting in foreign currencies.

At the same time, foreign banks have dramatically increased their presence in the United States (although expansion has slowed in the last several years). Does this imply lagging competitiveness by U.S. banks in their home market? OTA has found little evidence to suggest such an interpretation; foreign banks come here in part to gain experience in a highly competitive, deregulated, and technologically advanced industry; the very fact that U.S. financial services firms remain highly competitive internationally attracts foreign banks seeking to learn from U.S. experience. As in other industries, the size and wealth of the Nation's economy attracts foreign firms.

Many of the forces that have worked to the advantage of U.S. competitiveness in the past promise to continue to do so. But competitive patterns can and will change. Americans—both as individuals and as corporate officers—may think first of Merrill Lynch or Chase Manhattan when it comes to financial services, whether domestic or international. Japanese feel the same way about Nomura Securities and Fuji Bank. Nonetheless, U.S. automakers, who once bought all their steel from American steelmaker, now purchase overseas as well. Today, American corporations increasingly seek financing on the world market.

Competition among the world's major banks has tended to keep differences in the price and characteristics of services relatively small. Still, banks differ in corporate strategy, in marketing skills, in production efficiency. Seldom are these differences large enough to enable banks from one country to quickly or easily take business from foreign rivals who have comfortable working relationships with major customers. Over time, they do have a cumulative impact on market share and other indicators of competitive success.

But the financial institutions in the advanced industrial economies will probably not diverge very much in terms of the factors that determine competitive outcomes. Market forces will keep them close together (in the absence of massive changes in the world economy). Innovations in banking products and in back-office production technologies diffuse with considerable speed. Other governments are following the U.S. lead in deregulating financial markets. Both forces—technology and deregulation—point toward increasing convergence. If anything, the competition that already exists in the United States and in offshore markets—and the multinational character of U.S. banks—will give them ongoing opportunities to attract customers based in foreign countries. American banks that take advantage of these opportunities should continue to do well internationally.

The forces at work in financial services will also lead to greater cross-penetration of major markets, both domestically (in the form of regional and perhaps nationwide banking) and internationally. Moves by banks like Citicorp and Chase into regional U.S. markets find their analogs in competition in Tokyo and London, as well as New York, among banks and securities houses from many countries. British banks are moving in the same directions as American banks—and for many of the same reasons. The deregulation of the London stock exchange, the Big Bang of October 1986, will surely speed the convergence of financial services offered by U.S. and British firms (although London is currently behind in technology).

Deregulation in Japan has been slower, with Japanese banks less willing than their American counterparts to test the limits of existing laws and regulations. Even so, banks in Japan have been pushing for greater freedom of action for some time. In 1979, for example, arguing that restrictions on managing issues overseas only applied to public offerings, the wholly owned Swiss subsidiary of Fuji Bank took the lead role in managing a Swiss franc private issue for a Japanese construction company. These and subsequent thrusts by Fuji and other Japanese banks led to the de facto reinterpretation of parts of Section 65 of the Japan's Securities and Exchange Law, which controls the separation of commercial and investment banking in Japan .[23]

Internationally, with so many players in each market, price competition will continue to be intense. Customers will be able to switch easily among competing banks; the banks will be under constant pressure to hold down prices. Real or threatened competition will keep margins low, making financial services unprofitable by the standards of the late 1970s—not only in major world markets, but in many markets previously viewed as local or regional. In this competitive milieu, the leading banks from each country may well change, The big banks in the major industrial countries will be carrying the burdens of past mistakes for years to come; loan portfolios weighted down with Third World debt limit their strategic options. Emerging super-regional banks in the United States, with stronger balance sheets, may be able to take international business away from larger banks that must avoid new risks. At the same time, regional banks—in the United States, Japan, and elsewhere—will face much stronger competition in their traditional markets. As a result, the high profit levels of regional and super-regional banks will probably diminish.

Governments affect competitive dynamics in this industry through regulatory and supervisory policies, directly and indirectly. All governments view banking as a special industry. In seeking to protect depositors, particularly individuals (and for political reasons), they inevitably have an interest in the fortunes of individual banks. But national regulations have become increasingly difficult to maintain; when one country deregulates, others may have little choice but to follow. With national regulatory structures growing more porous, real dangers of instability on a global scale follow, Given ongoing integration in world financial markets, it may be time to seriously consider supranational regulation of those markets.

Governments not only regulate, some own and operate financial institutions. While postal savings banks, for example, may have no direct presence internationally, they can nonetheless affect competitiveness indirectly. Japan's postal savings system—the largest depository institution in the world—makes the Japanese Government cooler than it might otherwise be toward liberalization. By increasing competition for deposits—and, in effect, giving Japanese savers access to the higher market interest rates set internationally —liberalization would force the postal savings system to pay out more in interest.

As Japanese manufacturing firms continue to invest in other countries, Japanese banks will follow. As they do, they will mount more substantial and more sophisticated competitive challenges to the leading American financial firms, in this aided by Japan's very large holdings of foreign assets—a legacy of many years of trade surpluses. At this point, many of the decisions that will determine the pace and force of this challenge remain matters of domestic Japanese politics: if those advocating rapid change in Japan's own financial markets win, further penetration of Japanese banks into international financial markets will come quickly; if the conservative Ministry of Finance manages to hold onto most of its control over Japan's domestic markets, the pace will be slower.

What then of the outlook for U.S. financial service firms? Deregulation and new competition will, as always, make for winners and losers. Some foreign banks may continue growing faster than American banks, if only because they service faster-growing economies, Japanese firms like Nomura Securities will continue expanding in the United States to serve Japa-

[23] E. W Hayden, "1 nternationalizing Japan's Financial System," *Japan's Economy: Coping With Change in the International Environment*, 1). 1. Okimoto ({; (I.) [Boulder, CO: Westview Speoa 1 Studies Series, 1982], 1)1). 99-100.

nese (and American) clients. Leading U.S. institutions will report profits below traditional levels, some of the super-regional banks will flounder, some large banks may shrink dramatically. Mergers, possibly involving some of the biggest banks–U.S., Japanese, European–will continue,

By several measures, particularly in terms of asset size, U.S. banks have lost ground in recent years. Given the ongoing shift in international banking from lending to fee-based services, these losses—and the gains by Japanese banks–are not so serious as they would otherwise be. But a major competitive challenge to the American financial services industry is coming from the Japanese. The outcomes may be in doubt, but not the gravity of the threat to U.S. competitiveness.