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*The Transformation of the  
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Where Do We Go?  
Where Should We Go?*

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# The Transformation of the European Financial System – A Brief Introduction to Issues and Literature

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## 1. Introduction

At the end of the 1980s, given the long-term success of Japan and Europe in catching up with the United States in terms of GDP per capita, the question which model of capitalism has a comparative competitive advantage was clearly answered in favour of the former. Europe and Japan were praised for their specific modes of institutional arrangements combining the merits of long-term relationships between banks and lenders in investment financing with cooperative industrial relations that encouraged the accumulation of skills necessary for manufacturing competitiveness. In the U.S. the lack of cooperative industrial relations together with arms length financing was held responsible for discouraging long-term investment and finally inhibiting skills upgrading, resulting in a decline in U.S. industrial competitiveness.

About a decade later only, this assessment has been completely reversed. At the turn of the millennium the same institutional features that were held responsible for loss in competitiveness in the U.S. in the past were seen as the world best practice: Today it seems commonly acknowledged, that elements like flexible labor markets, shareholder value and strong incentive mechanisms led the foundation for the strongly growing ‘knowledge based’ new economy of the 90s. The Japanese economy on the other hand experienced a decade of stagnating growth with signs of ‘crony’ capitalism and institutions in Europe were all of a sudden considered inadequate in a period where technological innovation plays a decisive role.

But how can the mechanisms linking institutions, economic policy and growth change so dramatically and in such a short period of time leading to such a spectacular alteration in expert’s assessment? The usual response is perhaps that globalisation with its increased pressure for homogenization set off by the removal of barriers to trade and capital accomplished by the end of the 1980s brought about the necessity of transformations of institutions towards the U.S. style. But if convergence is in fact an inevitable requirement why do we not

observe clear signs of convergence, but instead a wide variety of different institutional responses in individual European countries (Amable 2003), where some adopt U.S. style institutions in some areas and others don't. Is it because 'incumbents' are inhibiting needed change (Rajan and Zingales 2003), as emphasised by some proponents in the literature? Or is it that institutions will adapt in a way to preserve institutional comparative advantage (Hall and Soskice 2001) which – given the varieties of capitalism prevailing (Amable 2003) – will not necessarily imply convergence towards the U.S. model but idiosyncratic country-level path-dependence. This implies that different institutional arrangements are conducive to similar macroeconomic performance. This view however rests on the idealized assumption that institutional arrangements are designed and are changed to increase economic efficiency, a view that for instance does not account for the frequently observed phenomenon of institutional change stemming from unintended consequences of actor's decisions (Streeck 2000).

The structure of the European bank-based system has been and is subject to several reform initiatives at the European and national level. While the focus of economist's research is to comparatively study the main determinants and impacts of different financial structures on economic efficiency, proponents of Varieties of Capitalism (VOC), a strand of comparative political economy literature, argue that policy initiatives to transform the European bank-based financial system towards the blueprint of more sophisticated U.S. financial markets might sequentially prompt institutional change in other complementary areas as well, ranging from industrial relations to vocational training (Hall and Soskice 2001). Whether this is an unintended consequence, anticipated or even intended is very much open to debate. However, in this view prevailing systems of financial and corporate governance do not exist in isolation but appear to be related to other key institutional features of the economies, including the degree of corporatism, social security and distribution of income, wealth and risk in the society. Hence, to avoid unintended consequences and to understand the driving forces of the transformation of the European financial system requires looking beyond the narrow research focus of economics. This may help to get more comprehensive insights regarding two broad issues:

- *First*, will the European financial system converge towards the U.S. style model?

- *Second*, as convergence, if it takes place, is not an inevitable outcome of market pressure but also an explicit or implicit expression of political choices (Boyer 2000), whether such convergence is desirable.

Regarding the later issue, the controversy about whether Europe should move towards a more market-based system is dominated by economist's views about the relative advantages of the financial structures promoting allocative efficiency, macroeconomic growth and, more recently, stabilisation. Here,

possible interaction effects among institutions are ignored. Hence, the VOC literature argues that the transformation of the financial system in Europe should not only be assessed against its implications on economic efficiency. This short introduction tries to summarize and to assess the recent findings of the literature in this respect.

Whether convergence will take place, the second issue that will be evaluated, is controversial. While proponents of the convergence hypothesis conjecture that regulatory reforms as for instance the introduction of fully funded pension schemes and initiatives at the European level such as the Financial Services Action Plan of the European Commission will unleash its full impact with some time lag in the next future others point to path dependency (Schmidt et al. 2002) or, in the case of Germany, to a hybridization process where the old path is transformed to a new one in an evolutionary way (Deeg 2001).

The paper starts by reviewing the recent literature on the impact of financial structure on economic efficiency and concludes that restricting the analysis on indicators of economic efficiency might probably be a too narrow approach given that other factors might also be an important source of welfare (Section 2). Section 3 discusses the hypothesis of institutional complementarities and the fundamental role of the financial system within this approach. As both questions raise the issue whether convergence will take place, and if it is desirable at all, are closely related to the nexus of financial structure and distribution of income and wealth four transmission channels of how the financial system might impact wealth and income distribution are discussed (Section 4). Section 5 gives an indication of the changes in financial and corporate regulation and financial structure that were observable throughout the last two decades in Europe. The paper closes by illustrating some likely prospects of the transformation of the European financial system.

## 2. Financial Structure and Economic Efficiency

Over the last decade, the economics profession's view of the relationship between financial development and economic growth has shifted fundamentally from one of neglect to the view that finance, by changing either the productivity of capital, the savings rate or the efficiency of financial systems (Pagano 1993), exerts a significant influence on economic growth - a view previously shared by economic historians comparatively investigating growth experiences of

countries.<sup>1</sup> A different strand of literature studying historical episodes of financial crises however reveal that under specific circumstances financial deepness might be associated with financial fragility and vulnerability to crises. Whereas the impact of finance on economic growth has been studied extensively both theoretically and empirically, there is little empirical evidence that relates financial deepness to the degree of cyclical volatility<sup>2</sup>

Even more surprising is our modest knowledge with respect to the mechanisms relating differences in financial structure that range from bank-based to more market-based systems to measures of economic efficiency, given the fact that the paradigm of financial liberalisation promoting market based systems was widely accepted before there was empirical evidence to relate it to economic efficiency (Wachtel 2001). There is a high degree of diversity in opinion in the existing literature which is by and large theoretical. These opinions range from the view that the specific type of the financial system is not important for explaining differential growth rates across countries, as supported by Levine's (2000) and Demirgüç-Kunt and Levine's (2001) empirical findings, to the view that either bank-based or market based financial systems are better suited to promote long-run growth. In general, these empirical findings have to be treated with caution as important institutional coherences might be ignored. If institutional features such as product and labor market regulation, industrial relations, welfare state arrangements, education and financial structure help to build up positive interactions, any growth regression should account for institutional complementarities.

Proponents of the market based view mainly concentrate on three arguments: First, financial markets may avoid the problems generated by powerful banks in exercising corporate control, as financial intermediaries may, in using inside information, extract rents from the firms and collude with managers against outsiders which in turn inhibits competition and long run growth. Corporate control by financial markets is mainly exercised by facilitating hostile takeovers, and by structuring compensation such as stock options.

Second, banks are supposed to be biased towards financing low-risk projects that are generally low return investments, as in the bank-based systems only a few managers decide whether funding of a project is worthwhile and funding of new technologies is less likely since future returns are highly uncertain. Allen and Gale (2000) argue that financial markets have considerable advantages in financing new projects, such as biotechnology, where little information is available and diversity of opinion prevails. In this situation financial markets

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<sup>1</sup> For an overview see Rousseau and Sylla 2001.

<sup>2</sup> For exceptions see Beck et al. (2001), Hahn (2003), Kaufmann and Valderrama (2004).

involve many potential investors in making investment decisions and at least some innovative projects are likely to be financed.

Third, financial markets are better suited in providing cross-sectional risk sharing by providing a vast range of financial products. At any point in time individuals can diversify their portfolio of assets. While financial markets have a comparative advantage in facilitating cross sectional risk sharing, the capability of diversifying aggregate risk across time, such as macroeconomic shocks is considered as one of the main advantages of bank based systems (Allen and Gale 1997 and Levine 2000). Such inter-temporal risk sharing requires that large reserves are accumulated in lower return safe assets which can only be made available by banks, since financial markets are continually adjusting their portfolio to receive the highest yield. By disposing over a large amount of safe assets banks may dampen aggregate shocks through a system of endogenous buffers. However, the bank's capability of providing intertemporal risk sharing is increasingly restricted by competition from financial markets (Allen and Gale 2000).

Another set of arguments in favour of bank based systems relates to corporate control: First, advocates of a bank-based system argue that fragmented ownership and liquidity of financial markets where investors can readily sell shares might inhibit efficient corporate control. Furthermore financial markets tend to underinvest in acquiring information on investment projects to be funded. This is attributed to a free-rider problem, which consists in this case of the fact that financial markets constantly reveal information in the public which provides investors with less incentive to acquire information by themselves. Thus, identification of innovative investment projects might be inhibited (Boot et al. 1993). This free-rider problem is less severe in bank-based systems as far as loans are not traded. Finally, the delegation of the costly process to screen investment projects to intermediaries saves transaction costs as duplication of information acquisition is avoided.

The empirical support for either of the two hypotheses, the market-based and the bank-based view based on cross-country studies using macroeconomic data is inconclusive and studies can be found promoting either the market-based view for countries with developed financial sectors (Tadesse 2002) or the bank-based view (Arestis et al. 2001). A more recent strand of empirical literature relating measures of financial development to economic growth in industries (Rajan and Zingales 1998) find that financial development disproportionately affects growth in industries that are more dependent on external finance. Carlin and Mayer (1999) establish a positive correlation between market-based finance and legal protection with the growth of equity-financed and skill-intensive industries, and particularly with investment in research and development. These findings indirectly support the view that financial markets and banks are complementary and foster growth in industries with different technological features. In this line

of reasoning Allen and Gale (2000) develop the argument that banks have a comparative advantage in funding firms belonging to traditional sectors, while financial markets are better suited to finance new technologies in high-risk sectors.

In general, research on the impact of financial structure on measures of economic efficiency is at an early stage. However, as a general result it seems that similar growth rates across countries are compatible with different financial structures and it is the degree of financial deepness that seems to matter for growth. Most of the literature discusses the impact of financial structures on economic growth, while little is known on how different financial structures affect the propagation mechanism of real and monetary disturbances. Hence, the open issue remains which financial system might be better capable of smoothing business cycles. Even more surprising is the modest knowledge about how income and wealth distribution are interrelated with financial structure, given the fact that not only economic efficiency but also equity is a major source of welfare and - at least from descriptive statistics - it is clearly visible that countries with arms' length financing having higher income and wealth inequality.

### **3. Financial Structure as Part of a Countries Institutional Framework**

Different models of market economies are constituted by a broad set of complementary and mutually reinforcing institutions such as industrial relations, innovation and training system as well as financial structure (Hall and Soskice 2001). Changes in the financial system which occupies a central position within the mutually reinforcing institutional complex of the economies should thus have significant consequences for the non-financial sector as well.

The great variety of financial systems across different countries of the industrialised world ranges from, at the one extreme, market-based financial systems where financial markets play a decisive role and banks are much less significant in savings allocation, and, at the other extreme, bank-based financial systems where banks are dominating and financial markets are playing a minor role, the financial systems in place representing combinations of these two polar cases. The binary classification between market- and bank-based financial systems implies that those countries that cannot be clustered along this

dichotomy are categorized as intermediate cases.<sup>3</sup> Hence, other authors have considered additional dimensions along which economies can be differentiated and distinguish three (Schmidt 2002) or five models (Amable 2003).

According to Hall and Soskice (2001) more bank-based financial systems are an integral part of coordinated market economies (CMEs).<sup>4</sup> In their analysis the role of financial systems in these economies is restricted to the function of exercising corporate control which is provided by banks. Since banks are capable to diversify aggregate risk over time (Allen and Gale 2000) the main focus of their monitoring function is on the long-term profitability prospects of the firm and less on short-term profit. Hence, the corporate governance system partly shields financing conditions from variability in firm's profits. This concurrently allows the firms to offer long-term employment contracts, to retain a skilled workforce through economic downturns and to invest in projects generating returns mainly in the long run. Monitoring the performance of firms requires private or inside information which reinforces dense business networks linking managers of banks and firms (through for instance cross-shareholding) and business associations. Availability of a labor force with high industry and firm-specific skills is more conducive to a specific production regime that favours incremental innovation as compared to radical innovation.

In CMEs business association are supportive to coordinated industrial relations. By equalizing wages at equivalent skill levels across an industry the poaching of skilled workers by other firms becomes less likely. Hence, the production strategies that depend on high skill levels and corporate commitment which is secured by long-term employment rely on corporate governance mechanisms that assure financing independent of short-term profitability considerations.

In contrast, governance mechanisms in Liberal Market Economies (LMEs)<sup>5</sup> encourage firms to be attentive to current earnings and to their share price. Monitoring is exercised through fragmented shareholders and information is provided publicly, hence, there is a lack of business networks providing investors with inside information. Industrial relations are organised through the market and firms do not engage in securing long-term employment. Flexible labor markets are congruent with an education and training system that relies on

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<sup>3</sup> Among the OECD countries, six take a more ambiguous position (France, Italy, Spain, Portugal, Greece and Turkey).

<sup>4</sup> Among the OECD countries, ten are classified as CMEs (Germany, Japan, Switzerland, the Netherlands, Belgium, Sweden, Norway, Denmark, Finland, and Austria).

<sup>5</sup> United States, Britain, Australia, Canada, New Zealand and Ireland are classified as LMEs.



general skills. Given short tenure and threat of poaching of employees by competitors, firms less invest in industry specific skills. Hence, weak employment protection and poor welfare state arrangements discourage investment in industry specific skills which would rapidly devalue in case of structural change and favour industry Specialization which more relies on general skills.

If complementarities are important a change in one institutional pattern will set in motion changes in other institutional subsystems, the speed and intensity of adjustment depending on the tightness of the coupling among these institutions. Deregulation of financial markets might put pressure on firms to increase short-term profitability which in turn eradicates corporatist arrangements between social partners concerning long-term employment, wage setting and investment in firm-specific skills. In this view a change in one subsystem results in instability and loss in comparative institutional advantage which puts pressure to adapt and reorganise the other institutional subsystems to rearrange a set of subsystems that is again coherent. However, how does this hypothesis tie in with the observation that the major reforms of corporate governance introducing Anglo-Saxon governance modes were implemented by centre left governments? (Amable 2003). Were the left parties simply unaware of the consequences such policy might entail for their clientele? Or is it an indication that complementarities are much looser than hypothesized or even nonexistent? The latter view is supported by Höpner (2003) who provides some appealing explanations of this 'paradox' at the background of the German experience. He also conjectures that in Germany there is indication of a new form of hybrid convergence evolving where Anglo-Saxon corporate governance modes coexist with strongly unionized industrial relations and codetermination.

#### **4. Financial Structure and Distribution of Wealth and Income**

Table 1 reports the Gini coefficients for two groupings of countries showing that bank-based economies in general have a more equal income distribution than market-based systems. The Gini coefficients of the countries that are classified as more bank-based vary from 0,247 to 0,266, while those that are categorized as market based had a much higher Gini coefficient, ranging from 0.311 in Australia to 0.368 in the United States.

*Table 1: Income Inequality in Selected Countries*

| <i>Country</i>                      | <i>Year</i> | <i>Gini Coefficient</i> |
|-------------------------------------|-------------|-------------------------|
| <b>Coordinated Market Economies</b> |             |                         |
| Finland                             | 2000        | 0,247                   |
| Germany                             | 2000        | 0,252                   |
| Sweden                              | 2000        | 0,252                   |
| Denmark                             | 1997        | 0,257                   |
| Austria                             | 1997        | 0,266                   |
| <b>Liberal Market Economies</b>     |             |                         |
| Australia                           | 1994        | 0,311                   |
| Ireland                             | 1996        | 0,325                   |
| U.K.                                | 1999        | 0,345                   |
| U.S.                                | 2000        | 0,368                   |

*Source: Luxembourg Income Study Key Figures ([www.lisproject.org/keyfigures/](http://www.lisproject.org/keyfigures/)).*

One might think of at least four different channels of how the financial structure might impact distribution of income and wealth. First, a direct and most dominant channel is the way how corporate governance modes have an impact on resource allocation among stakeholders and shareholders. Increased shareholder value restricts the capability to transfer resources from profitable sectors to less profitable ones. In an established market for corporate control the increased account of short-term profitability in an attempt to increase the return on equity will distribute income from stakeholders to shareholders (De Jong 1997). Using financial data on fifty-nine large German companies, Beyer and Hassel (2002) for instance show that the newly adopting Anglo-Saxon standards on corporate governance had a significant impact on the distribution of net value added. While supporters of an active market for corporate control claim that takeovers will direct corporate assets to more efficient uses, Shleifer and Summers (1988) argued that shareholders' gains less result from increased efficiency but from the ability of managers to breach the 'implicit contracts' of stakeholders. As employment perspectives of employees with industry-specific skills are not adequately protected by law, they are vulnerable to a 'breach of trust' that aims at distributing wealth to shareholders at the expense of long-term performance of the firm. The 'breach of trust' hypothesis is also supported by Deakin et al. (2002).

A second closely related channel through which financial structure impacts income and wealth distribution can be derived from the idea of institutional complementarities according to which convergence towards a market based financial system should change industrial relations and the way how conflicts of

interests between social partners are orchestrated. Centralized and coordinated wage bargaining as practiced by Scandinavian economies and Austria allows for more equal distribution of income which should change with more competitive industrial relations. Third, secondary distribution of income is also affected as the shareholder value has an impact on how risk sharing is organised in society. Fourth and closely related to the last two points is the role of hegemony of ideas in creating shareholder value and exerting a negative impact on income distribution. The latter is the most indirect but nevertheless not less important transmission channel. It is commonly acknowledged that differences between the U.S. American and European models of the firm reflect strong different cultural value preferences (Salacuse 2002). Europe's emphasis on social solidarity is in contrast to U.S. American cultural value which accord the individual wealthholder a dominant role. With regard to the corporation, the law considers individual shareholders as the firms' owners who are legally entitled to all its fruits. In this respect, concerns have been expressed that the replacement of the European system of corporate governance by the U.S. American will eradicate the European value system in general and make the principle of social solidarity less acceptable in society.

Those transmission channels establish possible links between financial structure and income distribution where causality runs from the first to the latter. Conversely, the level of income inequality might also have an impact on whether a financial system is more market or bank based (Vitols 2004) as different income groups demand different types of financial assets. This is well documented by a survey regularly conducted by the Federal Reserve Board (2003) which indicates that about 90 percent of the top 10% households in terms of income level have direct or indirect stock holdings, the latter including mutual funds, retirement accounts, and other managed assets, while the respective figure for the bottom 20 percent is 12.4%. One might argue that bank-based systems are better supported by risk-averse household sectors with lower income inequality. The fact that for instance German households' willingness to invest in risky assets is still limited may be attributed to the relatively low income inequality. According to Vitols (2004), a more unequal income distribution together with a further reform of the pension system to encourage more private retirement savings are major prerequisites for a major shift towards a market based system.

## **5. Some Recent Changes in the Financial Structure of the Euro Area**

Over the last two decades major European countries carried out substantial

regulatory changes promoting more market based financing, for example in the field of pension systems and corporate governance. As reported by Shinn (2001) almost all European countries included in his sample surveyed (Belgium, France, Germany, Italy, the Netherlands and Spain) have adopted features of the Anglo-American governance model in the 1990s except for the takeover legislation. In addition a major impetus to strengthen the role of equity finance originated in the privatization programs aimed at reducing the Maastricht debt ratios and to cut back the role of the state. However, the scope and timing of regulatory reforms was placed differently across countries.

The most far reaching regulatory change took place in France. It started to deregulate the banking system in the 1980s by abolishing interest rate ceilings, introduced futures markets and liberalised the Stock Exchange. The sizable privatization of French industry and banks, reforms of the governance systems and the introduction of a fully funded pension system were associated with a deepening of financial markets.

Germany has introduced the most important reform measures directly and indirectly promoting financial markets since the 1990s. Those include the initiative Finanzplatz Deutschland, measures for promoting the new economy, in particular public subsidies for venture capital, a pension reform in 2002 that shifts the balance away from the state pension towards the firm and individual pillars, and several initiatives to reform the corporate governance practices improving the quality of investor protection. By introducing stock option schemes for top managers previously unknown in Germany and adapting accounting rules towards U.S. standards large German firms increasingly oriented themselves towards the shareholder value. The German control and transparency law (KonTraG) of 1998 introduced another set of Anglo-Saxon corporate governance modes, such as the protection of minority shareholders and international accounting standards. In an effort to dissolve the common practice of cross-shareholdings, a major impediment to the development of market-based finance as it makes outsiders' investment more difficult to assess, a tax reform in 2000 abolished capital-gains taxes on the liquidation of those shareholdings, herewith loosening the ties between the firms and the banks. This increased the vulnerability of German firms to resist hostile take-overs, as denoted by the hostile takeover attempt of Thyssen by Krupp. Awareness of weakness of German firms to withstand hostile takeovers favoured a broad coalition against the European anti-takeover directive initiated by the European Commission that should facilitate takeovers and in general should make firms more sensitive to shareholders – at the expense of stakeholders – interests. The German takeover law adopted in 2002 contains almost all of the elements of the EU directive but tries to balance improved investor protection and continuing significance of stakeholder's interests (Hackethal et al. 2003).

Given the substantial changes in the regulatory system the question arises

how significant these changes have been for the financial structures. Interestingly, the few studies investigating whether throughout the last two decades, changes in financial structure indicate convergence towards arm's length financing, do not find any substantial convergence towards the U.S. model, an exception being Rajan and Zingales (2003). For the period 1980-1998 Schmidt et al. (2002) - by studying National Accounts Data for Germany, Great Britain and France, Japan and the United States - find no general trend toward disintermediation for the European countries with the exception of France where there has been a persistent move away from banks towards financial markets which reflects the consciously intended policy by the French state to create a reorganised financial sector based on the Anglo-Saxon model. Hackethal and Schmidt (2004) provide interesting historical information for the period of 1970 to 2000 on corporate financing of Germany in comparison with Japan and the United States. In Germany and Japan, banks were by far the most important source of corporate finance. In both countries bank financing in percent of the volume of long-term external corporate finance maintained its share at constant levels between 70% and 80%, while the contribution of U.S. banks declined from 22% to 14%. Equity and corporate bond financing only slightly increased to 18% in Germany and 17% in Japan while the upward trend was much more pronounced in the United States moving up from 36% to 53% between 1970 and 2000. While in Germany, small and medium-sized firms still rely on bank financing large firms however have become less dependent on this source of finance, while especially large banks seem to reduce their corporate lending activities (Hackethal et al. 2003) which might stimulate those banks to reduce active involvement in corporate governance in the future. In France, the share of bank loan financing has decreased for all firm size classes. Similar qualitative results have been obtained by Hartmann et al. (2003) for the period 1995 to 2001 in the euro area.<sup>6</sup> The major change they identify is an unprecedented boom in corporate bond financing, partly unleashed by the introduction of the euro and to some extent by the liberalization of telecommunications business and merger and acquisition activities.

Furthermore, privatization policy implemented by several euro area governments was the main explanatory factor behind increased market capitalization of euro-area stock exchanges. When correcting for price increases annual growth rate of market capitalization between 1998 and 2001 was even higher than in the U.S. and in Japan but this trend partly reversed in 2001 and 2002. However Hartmann et al. (2003) conclude that both the bond market boom

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<sup>6</sup> This study partly relies on a report by the ECB (2002) on financial structures compiling data provided by national central banks.

and some growth in equity finance have not led to a noteworthy shift to arm's length financing. Surprisingly, they find that since the mid of the 1990s financial structures have been diverging across euro area countries except for bond market financing.

To sum up the financial structure indicators looked at in isolation do not signal fundamental change in financial structure. Whether this holds true from a systemic perspective, whether those European countries that traditionally were considered stakeholder-oriented insider control systems combining different institutional characteristics in a complementary way, can still be categorized as such is rather unclear? In Germany, for instance, the stakeholder system of corporate governance seems to be intact. The role of codetermination, the representation of trade unions in the supervisory boards, which constitutes an important element of the stakeholder-oriented insider control system, has even been strengthened in 2001. On the other hand there is evidence of reduced involvement of large banks in corporate governance (Hackethal et al. 2003).

## 6. Any Convergence of Financial Systems in the Future?

In reviewing recent developments in corporate governance in the European Union a number of authors take contrasting views concerning the issue of future convergence of financial structures. From a neo-institutionalist perspective (Williamson 1985) convergence is seen as an inevitable result of rational micro-behavior when adopting most efficient best practice standards. As single market measures continue to take effect this will lead to gradual convergence of financial structures towards U.S. modes. Conversely, the 'institutional complementarity thesis' theoretically underpins the possibility of plurality of models, each corresponding to local and national circumstances (Hall and Soskice 2001). Within this broader perspective, financial structures are not analysed in isolation but as one subsystem among several complementary institutions, while the various sets of institutions form the basis of comparative institutional advantage. Change in the direction of U.S. standards might also be inhibited by political factors, such as local vested interests repressing arm's length financing, as stressed by Rajan and Zingales (2003). A different view establishing obstacles to further rapid convergence is put forward by La Porta et al. (1998) who stress the important role of the legal tradition in explaining current persisting diversities in financial structures. While common law countries, in protecting private property rights, developed well-functioning financial markets, countries with a civil law tradition that promoted a stronger role of the state to interfere with the financial system are – according to this view - inherently less dynamic in adapting to new conditions. While the literature is usually inclined to discuss dichotomies, some authors pointed towards the

likelihood of hybrid convergence taking place (Hackethal et al. 2003). Hence, as concluded by Reberioux (2002): “The outcome of the confrontation between two competing trends, the affirmation of the European model of corporate governance and the spreading of shareholder value, is highly uncertain.”

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