UNIVERSITY OF CALIFORNIA, SAN DIEGO

The Political Economy of Financial Systems:

Explaining Varieties of Capitalism

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requirements for the degree Doctor of Philosophy in

Political Science

By

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ABSTRACT OF THE DISSERTATION

The Political Economy of Financial Systems:

Explaining Varieties of Capitalism

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Capitalist economies can arrayed along a spectrum between liberal market economies and coordinated market economies: firms depend more heavily on markets in the former and more on non-market mechanisms in the latter. Whether the financial system privileges markets (securities markets) or non-market mechanisms (banks) offers a powerful

indication of the capitalist system more broadly. Thus, to explain varieties of capitalism, I ask a narrower question: why do countries have different financial systems?

Since WWII, countries such as the US, UK, and Canada have depended more extensively on securities markets for mobilizing capital, while countries such as Germany, France and Japan have relied more heavily on banks. Prior to WWII, however, France and Japan were more reliant on securities markets.

In contrast to arguments based on legal institutions and alternative interest group explanations, I argue that the structure of a country's financial system, and its capitalist system more broadly, primarily depends on the political power of large firms, who usually prefer markets, relative to that of labor, farmers, and small firms, who generally prefer banks. The implications of the argument extend to our understanding of economic growth, the nature of technological innovation, globalization's varying effects across nations, and corporate governance. My argument is supported with econometric evidence from industrialized nations between 1950 and 1990. The dissertation also presents evidence from the history of financial regulation in France and Japan since the late nineteenth century, using a mixture of quantitative and qualitative analysis.

Chapter 1

Introduction

Capitalist economies come in many varieties which can be arrayed along a spectrum between two ideal types: liberal market economies and coordinated market economies.[1] In liberal market economies, markets play a larger role in mediating actors' interactions in different spheres of the economy such as finance, employment protection, corporate governance, etc.[2] In coordinated market economies, actors depend more heavily on non-market relationships. For example, the US, UK, and Canada are closer to the liberal market economies pole while other nations such as Italy, France, Germany, and Japan are closer to the coordinated market economies pole. Why capitalist economies differ from one another remains uncertain and controversial.

Hall and Soskice (2001) observe that different spheres of national economies are complementary to one another. By this, they mean that nations with a particular type of coordination in one sphere of the economy should tend to develop complementary practices in other spheres as well. Aoki (1994), for example, argues that long-term employment is more feasible where the financial system provides capital on terms that are not sensitive to fluctuations in short-term profitability, as with bank lending. Because of these complementarities, a useful way to explain varieties of capitalism involves identifying and explaining one particular sphere with broad implications for the rest of the economy.

As this example suggests, whether the financial system is more dominated by markets (securities markets) or non-market mechanisms (bank lending) can have strong complementarities to other spheres of the economy, making it a powerful indicator of the capitalist system more broadly. Indeed, how capital is transferred from savers to borrowers is at the heart of any economy. Thus, to explain why countries have different kinds of capitalism, I ask the narrower question: why do countries have different financial systems?

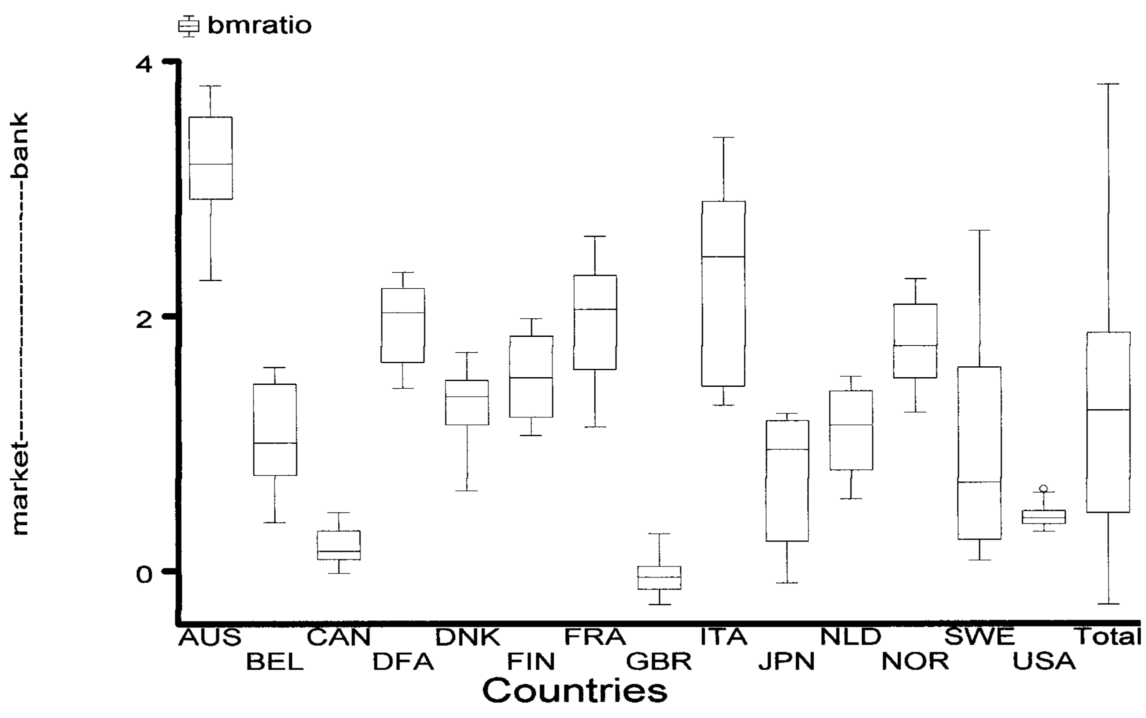
Surprisingly high levels of variation in the structure of national financial systems are found both across countries and time. During the contemporary period (from 1976 to 1990), Italy has, on average, been more reliant on banks than France, followed by Germany, Japan, the US, Canada, and the UK.[3] However, at the beginning of the twentieth century, Japan and France relied far more heavily on securities markets, resembling the contemporary liberal market economies of the US and UK. Why did they change?

I argue that the structure of national financial systems depends on the political power of large firms, who usually prefer markets, relative to that of labor, farmers, and small firms, who generally prefer banks. In this respect, I differ from two kinds of arguments: those in economics and history that underplay politics and emphasize the effects of national legal systems (e.g., La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998); and those that consider politics as important, but which emphasize different interest group cleavages (e.g., Rajan and Zingales, 2003; Pagano and Volpin, 2000; Gourevitch and Hawes, 2002; Roe, 2002). I plan to develop an argument and to present evidence illustrating that my theory is stronger than either set of alternatives.

The rest of the chapter is divided into six sections. In section one, I outline the empirical puzzle. In section two, I provide a review of other explanations for the structure of countries' financial systems. The third section summarizes the main argument. In section four, I detail some of the practical and theoretical implications of this research. The fifth section explains the methodology used to test the strength of my argument relative to the alternative explanations. Finally, section six outlines the organization of the rest of the dissertation.

The Puzzle

Figure 1.1 illustrates 14 OECD countries' bank-market orientation for the contemporary period, 1976-1990.[4] These orientations are determined by taking the ratio of bank assets to stock market capitalization, a commonly used measure in finance.

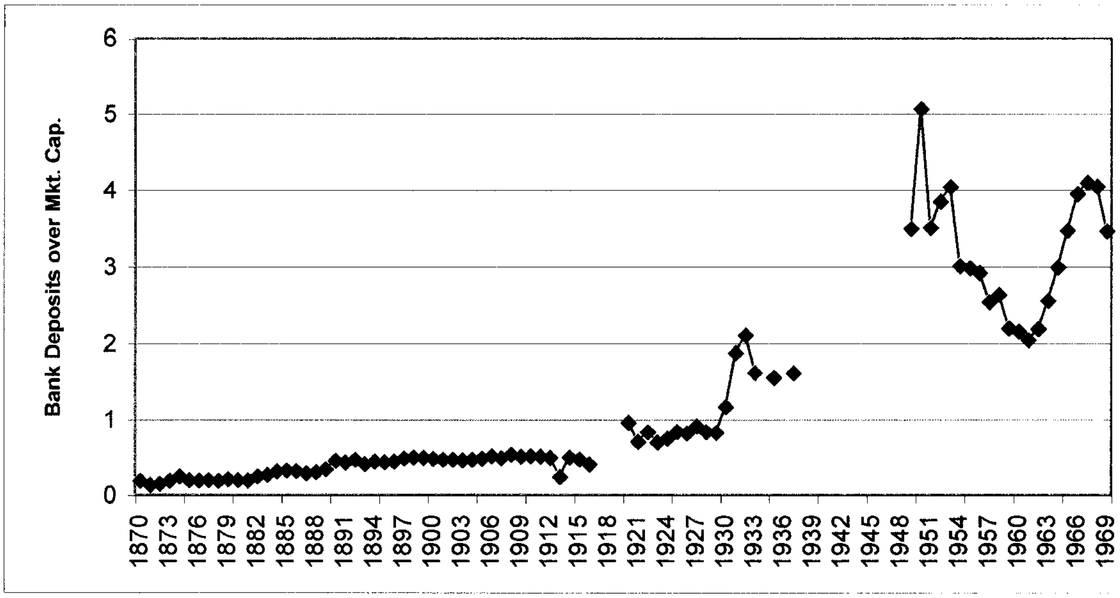


Data Source: Beck, Demirguc-Kunt, and Levine. "A New Database on Financial Development and Structure." 1999.
Note: AUS = Austria, DFA = Germany

Figure 1.1: Box Plot of Bank-Market Orientation by Country, 1976-1990

The figure clearly illustrates the variance among the 14 OECD countries with respect to the orientation of their financial system. Because the data varies from a low of 0.77 (GBR) to a high of 44.7 (AUS), I have taken the natural log of the ratio of bank assets to stock market capitalization to ease comparison since it more clearly highlights the differences among countries with similar ratios. The line in middle of the box indicates the median. The length of the box extends from the lower quartile (25%) to the upper quartile (75%) of the data, thereby capturing the middle 50%. The whiskers extend to 1.5 times the upper and lower quartile points, or the maximum and minimum points if they are less than the formula for the length of the whisker. The circle above the whisker for the US indicates the maximum point. Longer boxes and whiskers indicate more variance in the data during the period 1976 to 1990. To see the bank-market orientation of each country over time without the logarithmic transformation, please refer to Appendix 1A.

While the box plot confirms the widely held view that France and Japan rely more on banks than their Anglo-Saxon counterparts, at one time they relied much more on their securities markets.[5] Prior to the 1930s, France relied far more heavily on markets as the conduit by which money flowed from savers to borrowers. The following figure illustrates the change:



Data Source: Michèle Saint Marc, 1983, Histoire monétaire de la France, 1800-1980, pp. 56-7, and Michèle Saint Marc, 1974, "Introduction aux statistiques monétaires et financières francaises (1807-1970)", in *Journal de la Société de Statistique de Paris*, 115 Année, No 4 – 4e Trimestre, p. 334.

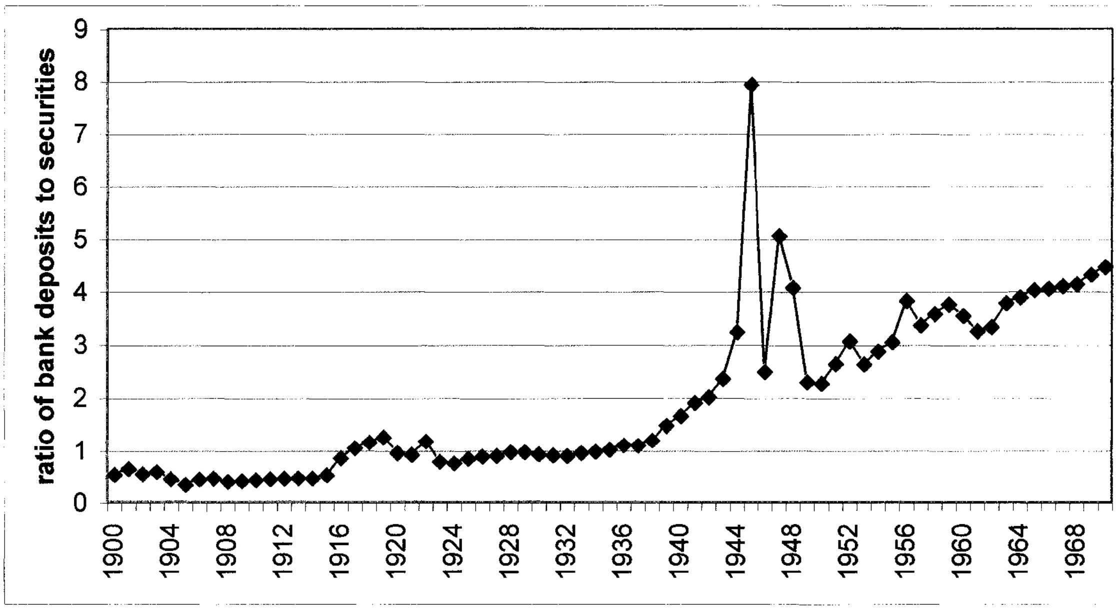
Figure 1.2: France, 1870-1969: Bank Deposits over Stock & Bond Market Cap.

To provide an overall picture of France's financial system, André Gueslin (1992) summarizes the state of affairs from 1880 to 1930:

> The crisis of the 1880s brought to an end the preliminary phase of banking development in France: it consolidated the position of the great credit institutions and generated a policy of management rationalization which was coupled in due course with an 'industrial disengagement'. It inaugurated the 'golden age' of a finance-market economy. The crisis of the 1930s marked the end of this period. Using modern economic concepts with care, I mean by this that, throughout the period, banking credit remained more or less limited and the financing of the economy came about through the accumulation of savings: primarily as companies directly used parts of their cash flow, but also by the transfer of domestic savings via the financial market.

Around the same moment in time, Japan also shifted from arms-length to bank financing. Data from Hoshi and Kashyap (2001) on the allocation of private sector assets from

1900-1970 show the clear long-term trend.



Source: Hoshi and Kashyap, *Corporate Financing and Governance in Japan.* 2001.[6]

Figure 1.3: Japan: Allocation of Private Sector Assets, 1900-1970

The financial system from the late nineteenth century up to the hostilities with China in the late 1930s was characterized by the low importance of banks in the financing of corporations. In contrast, securities markets were quite important. Hoshi and Kashyap (2001) observe that:

> New shares were routinely issued by the leading corporations and shares were traded actively on stock exchanges and over-the-counter. The trading was done by a diverse group; the banks as a rule did not own much equity and the notion of "shares held in friendly hands" was rarely mentioned. Bond markets were also deep and vibrant. It was not unusual to see years where more net corporate funding was done in bond markets than through bank borrowing.
>
> The late 1930s and early 1940s was the time when bank financing became the dominant funding source for most of the industrial firms involved in the war effort. During this period the depth of the ties between specific firms and banks increased noticeably. The shift was completed with the designation of specific banks as being responsible for the

> financing of specific militarily important firms. This meant that the lending coalitions that had previously characterized banking relations were replaced by one-on-one lending. In many ways this shift marked the start of the tight ties between firms and banks that is the hallmark of bank-centered financing.[7]

Thus, while Japan and France are commonly thought of as banking-oriented, they clearly were not always so. I illustrate the change for France and Japan because it offers a useful way to check the robustness of explanations regarding the structure of countries' financial systems. That is, a persuasive argument regarding the bank-market orientation of national financial systems will be able to explain both the variance among OECD countries for the contemporary period, as well as the structure of developed countries' financial systems over the course of the twentieth century.

Explanations

I argue that the structure of a country's financial system primarily depends on the political power of large firms relative to that of labor, farmers, and small firms. This argument differs from the other major arguments found in the literature, which I classify as incomplete contracting, legal systems, coalitional governments, left-right partisanship, and incumbency and openness arguments. I discuss each in turn.[8]

The incomplete contracting perspective claims that as information technology and property rights improve, financing through capital markets becomes less costly and more feasible for smaller economic actors who would previously only transact through banks.[9] Thus, not only can more actors transact via a marketplace as contractual incompleteness diminishes, but the costs also decline for actors who already participate in capital markets financing. Since information dissemination and analysis costs have constantly declined during the twentieth century, and property rights are, on average, no worse than they were at the beginning of the century (and likely better in most cases), we should expect countries to move steadily toward a greater reliance on capital markets financing.

Clearly, however, this has not happened. Figure 1.1 reveals that there are considerable differences among OECD countries' financial systems, despite their similar levels of development (a reasonable proxy for their levels of contractual incompleteness). It is also difficult to explain the move from arms-length dominated to intermediation-dominated financing without any significant changes in information technology or property rights, as occurred most notably for France and Japan.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 1998) seek to resolve this dilemma by turning to a legal systems explanation. They argue that common law countries are more market-oriented than civil law countries because of the legal protection they afford investors. In common law systems, judge-made law (common law) coexists with statutory law, which is found in Anglo-American states such as Britain, the US, New Zealand, Australia, and Canada. In civil law systems, by contrast, only positive law is considered legitimate, and is found in most other democracies, but is especially prominent in Europe. An important distinction between the two systems is that common law judges make law through application of the common law, interpretation of statutes, and review of legislation; civil law judges do not make, interpret, or review law--they merely apply the laws made by legislatures. Consequently, common law judges are portrayed as both more powerful due to their greater discretion; civil law judges are portrayed as disinterested, neutral civil servants who simply execute the will of the legislature.

Because common law judges can make rulings based on whether a defendant has violated the spirit of the law, investors in these countries have greater protection from managers' actions that violate the law's intent. In civil law countries, on the other hand, if a manager does not contravene an explicitly detailed edict, courts have a more difficult time punishing the manager.

LLSV provide impressive statistical evidence for the importance of legal systems across developed and developing countries for the contemporary period. However, their argument is not robust when tested across the entirety of the twentieth century since France and Japan, which both have civil law systems, were market-oriented at the beginning of the century. It is likely that legal systems are masking an underlying political explanation, at least in developed democracies. Recent research on political influence in the American judicial system illustrates that politics influences court decisions even in a common law country (McCubbins, Noll, and Weingast, 1995; Spiller, and Gely, 1990; DeFigueiredo, and Tiller, 1996; Zuk, Gryszki, and Barrow, 1993; Zuk, Barrow, and Gryszki, 1996). Consequently, scholars have turned their attention to political institutions for an answer. For example, there is a strong correlation between a countries legal heritage and its electoral system. The following table illustrates that countries with common law also have a plurality electoral system; nations with civil law have proportional representation systems.

Table 1.1: Countries' Legal and Electoral Systems Since WWII[10]

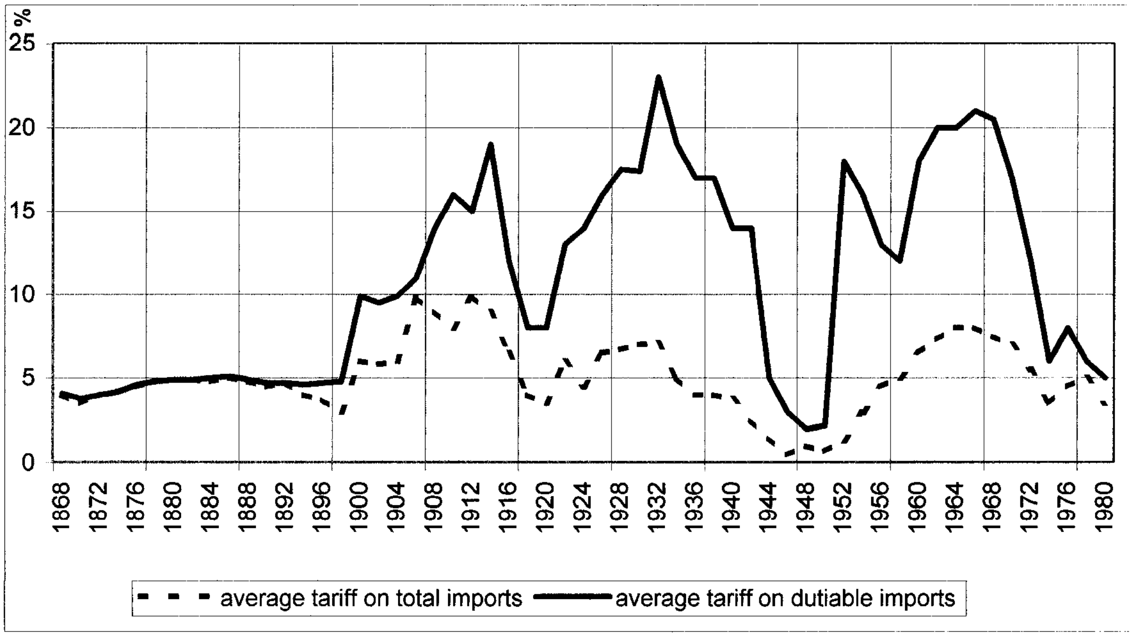
14 OECD Countries in my Sample	***Legal System***	***Electoral System***		*Additional Countries*	*Legal System*	*Electoral System*
Austria	German Civil	PR		Australia	Common	Plurality
Belgium	French Civil	PR		Colombia	French Civil	PR
Canada	Common	Plurality		Greece	French Civil	PR
Denmark	Scan. Civil	PR		India	Common	Plurality
Finland	Scan. Civil	PR		Ireland	Common	PR
France	French Civil	Majoritarian (except 1986 when it was PR)		Israel	Common	PR
Germany	German Civil	PR		New Zealand	Common	Plurality (1946-93) PR (1993-)
Italy	French Civil	PR		Portugal	French Civil	PR
Japan	German Civil	Semi-PR		Spain	French Civil	PR
Netherlands	French Civil	PR		Switzerland	German Civil	PR
Norway	Scan. Civil	PR		Venezuela	French Civil	PR (1958-88)
Sweden	Scan. Civil	PR				
UK	Common	Plurality				
USA	Common	Plurality				

Proportional representation electoral systems permit the formation of coalition governments. Accordingly, Pagano and Volpin (2000) make the appealing argument that workers and entrepreneurs can reach a political agreement whereby low investor protection is exchanged for job security in countries that favor coalition governments, as in continental Europe. However, such bargains may be struck in countries that do not favor coalition governments, such as France, suggesting that the political power of the groups themselves, rather than the political institutions, play the crucial role.

Gourevitch and Hawes (2002) acknowledge the importance of interest group political power in their article examining the effects of political institutions on the structure of national economies, and this is echoed by Gourevitch (2003) in his review article of Roe's book, *Political Determinants of Corporate Governance* (2002). Roe argues that left-wing political parties seek to mitigate the deleterious effects of capital markets on employees' employment stability by privileging blockholders over shareholders. It should be noted, though, that Roe's dependent variable is the diffusion of firm ownership across industrialized nations, not the financial system. But it is worthwhile to consider his argument since firm ownership (i.e., capital providers), whether in the form of blockholders or shareholders, has important implications for the structure of the overall financial system. The evidence presented is tantalizing, though incomplete, since it fails to control for other variables and has such a small number of data points (sixteen). Assuming that the findings are robust, Gourevitch suggests that Roe's argument could be strengthened by considering the role of coalitions and political institutions. For example, in international trade theory, the Stolper-Samuelson theorem assumes that labor is perfectly mobile and that factors will seek free trade when they have a comparative advantage, and form coalitions accordingly. The Ricardo-Viner theorem assumes that as labor becomes more specialized it will form a sectoral coalition with capital and that these sectors will seek free trade when they have a comparative advantage. Either model could be correct depending on the historical period; Hiscox (2001) illustrates that when labor is not specialized, trade policy conflict occurs along class lines, but that as labor becomes more specialized, it forms the expected political coalition with capital, and trade policy outcomes reflect this. In addition to coalitions, Gourevitch comments on the need for a consideration of political institutions, which mediate these actors' interests and privilege particular policy outcomes over others. Because Roe focuses exclusively on the separation of ownership, and not the financial system, we must be mindful that additional differences will merit attention in this regard, and will be discussed in the theory chapter.

Finally, Rajan and Zingales (2003) argue that increasing international trade and capital flows give rise to a greater reliance on capital markets because incumbents' opposition weakens. The evidence offers support for their argument, but there remain theoretical and empirical problems. Theoretically, Rajan and Zingales's argument suffers from an endogeneity problem: openness is determined by domestic political actors who may also have strong preferences regarding the structure of the financial system (Gourevitch, 1986). For example, capital-intensive industries in capital-abundant states may favor openness because of their comparative advantage, and they may likewise prefer market-dominated financing. A second problem regards the proper identification of the incumbents and assessing their political power.

Empirically, we are faced with the puzzle of why the US and UK relied on capital markets throughout the twentieth century, regardless of the level of international trade and capital flows. Further, why did Japan rely heavily on markets before WWII although Japan's tariffs varied considerably, as illustrated in figure 1.4?[11] And why do some countries continue to rely more heavily on banking finance than others, despite the general trend toward markets in the contemporary period?



Source: Adapted from Minami, 1986, *The Economic Development of Japan*, 251.
Note: In the prewar period, Japan was on the gold standard from 1896 to 1917, and from January 1930 to December 1931, in order to promote international trade and finance.[12]

Figure 1.4: Customs Duties in Japan, 1868–1980

I now turn to my argument, which seeks to resolve these, and additional, questions.

Summary of the Argument

I argue that the structure of national financial systems depends on the political power of large firms relative to that of labor, farmers, and small firms. To concisely summarize my argument, I: (1) identify the relevant actors; (2) deductively derive their financial system preferences; (3) map out likely coalitions; and (4) specify how political institutions mediate actors' political power and lead to various policy outcomes regarding the financial system.

I focus on large firms, labor, farmers, and small firms because they usually wield the greatest political and economic power across developed democracies, and because they have strong preferences regarding the structure of the national financial system. Of all of these actors, small firms usually have the least influence. This is not to say that they are unimportant, but their political power is not as strong nor as easily measurable. For this reason, I look at their role in the case study chapters rather than in the large-n quantitative analysis. Other actors may also play a role in lobbying for a particular type of financial system (e.g., entrepreneurs), however, their political influence is likely far smaller than the groups discussed here. The following table summarizes the preferences of the key actors:

Table 1.2: Actors' Preferences

Bank	Market
1. Big Firms (sufficiently subsidized loans)	2. Big Firms
Small Firms	
Farmers	
Labor	

Firms want to borrow money cheaply; that is, at the lowest rate available. Large firms usually prefer markets because they have lower transaction costs than bank lending. Because large institutional investors seek financial instruments with high levels of liquidity, large firms' stocks and bonds are attractive. Consequently, institutional investors are willing to overcome the collective action problem of obtaining detailed information about these firms in order to accurately calculate the appropriate price at which to offer them financing, reducing the risk premium that would result from a lack of information.[13] Because markets permit sellers and buyers to directly transact with one another, markets reduce the transactions costs that occur with banking finance. Thus, markets offer cheaper financing than banks to large firms, ceteris paribus. In some circumstances, however, the government may offer subsidized loans via banks to large firms that are less costly than selling equity or bonds on securities markets. Such subsidized lending is likely to occur when large firms are uncompetitive in their main foreign markets, and when international trade and capital flows are low which frees the government from worrying as much about its balance of payments and related macroeconomic policies. For example, many European countries offered subsidized lending to large firms following the devastation of WWII.

Subsidized lending can be difficult to sustain as pressure intensifies on the government to maintain sound macroeconomic policies as international trade and capital flows increase, forcing it to limit the amount of subsidized loans it offers to large firms.[14] This in turn leads to the bolstering of domestic securities markets. For example, in 1982, the French Socialist government was forced to drastically reduce the volume of subsidized lending made to large firms in order to deal with balance of payments problems. It also began passing legislation promoting securities markets. A second reason why increasing international capital mobility leads to a greater reliance on securities markets is that large firms can more easily exit the country in search of cheap financing from foreign markets, forcing the home country to bolster its own markets to keep their financing business at home. Because subsidized lending is difficult and expensive to sustain over a long period of time, I argue that large firms usually prefer markets to unsubsidized bank lending (the more common alternative).

In contrast to firms' desire for cheap capital, labor seeks relatively high and stable employment and wage levels, along with other social services. By controlling the means of extending credit and finance to business, labor--and left-wing parties who have similar goals--can extract concessions.[15] They do this by offering targeted lending incentives to industries and even specific firms, and by punishing firms that fail to fulfill their obligations. Banks (and intermediaries generally) are more useful in this role than markets, which are decentralized and not easily controlled by political leaders. Thus, labor prefers banking-dominated financial arrangements so they can manipulate lending conditions in order to fulfill their employment, wage, and social services objectives.

Labor also prefers that corporations use bank financing because it reduces employment and wage volatility associated with markets. Specifically, when a downturn in the business cycle ensues, labor is likely to be laid off or their wages reduced as managers seek to protect the firm's profits. The long-term nature of banking finance permits the firm to intertemporally smooth the volatility associated with the business cycle, and with markets generally speaking. Thus, banking finance adds stability to labor's employment and wage levels, and labor will champion corporate governance regulations that favor banks.

Like big firms, farmers desire a cheap supply of capital. Because markets allow capital to find the highest rate of return with regard to risk, capital tends to leave the rural sector as economies industrialize and modernize. Consequently, farmers seek to redirect capital back to the rural sector since it will reduce their borrowing costs, and banks are necessary for this task.

Farmers also prefer banks because they are more likely to have sufficient information about them to determine the appropriate rate at which to provide them with financing. Without a high level of information, a risk premium would have to be charged to compensate for the increased risk of making a loan. Indeed, markets are likely to charge farmers a higher rate than banks for this reason. This results from a collective action problem (or free-rider problem) since no one investor is willing to invest the time and effort to investigate every farmer, thereby creating a higher risk premium. Thus, farmers (and small firms) prefer small, local banks insofar as they have an informational advantage.

Finally, banks are willing to provide much-needed financing in difficult times because of the long-term nature of their relationship. This helps to smooth out the volatility associated with changes in seasonal weather patterns and uncertain crop yields. This is especially important to farmers (and small firms) since their ability to diversify among different crops and livestock is limited. Differences between farmers and small firms, as well as much greater elaboration on these actors' preferences, are discussed in chapter two.

Assuming that these actors' preferences are correctly identified, we must next consider how they influence the structure of the financial system. Each actor wields both economic and political power. Large firms seek capital market oriented financing with their financial contributions to politicians (political power) and with their ability to exit the home country in search of cheaper financing in the international marketplace (economic power). The latter option puts pressure on the home country to become more market-oriented in order to retain these firms' financing business (e.g., France in the mid-nineteenth century as Freedeman, 1993, describes).

Labor seeks banking-oriented finance via its bargaining power with large firms (economic power) and through left-wing parties' political power, which is determined by votes at the ballot box. Farmers' economic power arises from the proportion of a country's GDP originating from the agricultural sector, and their political power also arises from their votes at the ballot box.

Next, we must consider how political institutions magnify or reduce these actors' political influence. The extent of interparty and intraparty diffusion across electoral systems has a considerable impact. Interparty diffusion refers to the tendency of electoral system rules to encourage the creation of few or many political parties. Plurality systems are at one end, where two parties compete for the median voter, with proportional representation systems at the other end, where many parties compete. Party diffusion is important because proportional representation systems generally favor the political representation of labor, while plurality systems discourage it.

Intraparty diffusion refers to the candidate or party-centeredness of an electoral system. In candidate-centered systems, politicians seek to build personal reputations and a loyal constituent base which usually requires heavy campaign expenditures, thereby creating a dependence on the financially powerful—big business—and on organized local voters—farmers and small business. Consequently, candidate-centered systems offer incentives for politicians to cater to the financing preferences of big firms, and to offer banking institutions that privilege farmers and small firms. In more party-centered systems, candidates depend more on the reputation of their party during an election, which reduces their incentive to focus on a small group of loyal voters. The political institution that has the greatest influence on farmers' political power is malapportionment (Lijphart, 1999). Higher malapportionment means that rural voters get more representation than they deserve, and thus more political power.[16]

Coalitions are likely to form among these actors. For example, more important than the independent influence of labor and farmers is their combined influence since the legislators representing each group are more likely to overcome veto-gates, get 50%+1 of the legislative votes, and more capably enforce banking-oriented regulations when acting in concert than when acting alone. Additionally, labor is more likely form a coalition with large firms when subsidized loans are feasible (with low levels of international trade and capital flows).

Because farmers, small firms, and labor all prefer banks, they will seek to bolster the role of intermediaries in the national economy. For example, during the Popular Front in France (1936–1938) representatives from the left, small business, and rural areas passed legislation that diluted wealthy elites' (the '200 families') control of the Bank of France (the most important financial institution) by adding a considerable number of representatives to its board of directors so that it came under government control (and at this time, labor and rural interests controlled the government).

However, these actors also have different goals with regard to enhancing banks, so they will frequently seek different kinds of banks and intermediation activities. For example, wealthy rural landowners pushed legislation through in 1894 that created the precursor to the Crédit Agricole through a network of local cooperatives to service these actors' financing needs. At this time, labor had negligible political power. During the postwar period, on the other hand, left wing politicians sought to influence the actions of large enterprises partly by using "sticks" (e.g., refusal of access to the capital market or to long and medium-term credit, or placing at the back of the queue for funds) and partly by distributing special "carrots" (direct and indirect subsidies, tax exemptions, rediscounting of loans, and other favors) that directly involved the use of France's largest banks. The implementation of these actions primarily depended the partisan make-up of the parliament and the president.

The policies enacted and enforced by the government influence the structure of the financial system in tandem with the economic power of these actors. Whether these actors' political power or economic power has a greater impact on the financial system will be examined with the large-n quantitative analysis and with the case studies.

Certainly, other aspects of countries' political systems contribute to these actors' political power (e.g., the US Senate's filibuster, and whether a country has an upper legislative house and the extent of its power). However, parsimony privileges those variables that have the widest applicability and explanatory power across industrialized democracies.

Practical and Theoretical Implications

Explaining this puzzle has several practical and theoretical implications.[17] First, developing capital markets can greatly facilitate a nation's economic growth (e.g., Demirguc-Kunt and Maksimovic, 1998; King and Levine, 1993; Jayaratne and Strahan, 1996; and Rajan and Zingales, 1998). However, national economies that rely heavily on markets are more susceptible to the negative consequences of investors' short-term objectives and to market volatility. For example, firms in market-oriented economies are more likely to layoff workers during a downturn in the business cycle in order to preserve profit margins and to prop up the stock price. With regard to volatility, consider the 1970s oil shock, which caused steep declines in the stock market valuations of firms; American households, who keep a high proportion of their assets in the form of equity, saw their assets decline far more than German households, who keep more of their money with banks.

The nature of technological innovation is another area of practical significance. Markets more effectively promote radical innovation, while bank lending privileges incremental innovation. Because markets permit individuals to make different investing decisions, as opposed to banks where individuals delegate decision-making to an intermediary which requires investors to make a compromise, markets may have a significant advantage over intermediaries in situations where a diversity of opinion is important, such as the financing of new technologies. For example, the internet revolution occurred in the United States partly because risk-acceptant individuals could easily invest their money in companies such as Yahoo and eBay.[18] Other industries that focus on radical innovations include biotechnology, semiconductors, and telecommunications. The longer-term financing available with banks, however, privileges incremental innovation, which has been of particular importance to industries such as consumer durables, machine tools, and transport.

Corporate governance is a third area in which there are important practical implications. In liberal market economies, securities markets are more frequently used than bank lending for the external financing needs of large firms. In these cases, shareholders exercise greater influence over the firm. In coordinated market economies, firm ownership is more concentrated in the hands of one or a few owners, and banks and labor have more power. Because shareholders' interests frequently differ from those of banks and labor, firms in the same industry but from different countries may differ in how they solve similar problems and how they weight various priorities. For example, the merger between Daimler-Benz and Chrysler required more extensive negotiations and creative solutions regarding workers' rights and corporate governance issues than would have occurred between two firms from the same country. Resolving conflicts of interest arising from different corporate governance rules is becoming increasingly important as evidenced by the value of cross-border mergers and acquisitions in Europe, which increased from $100 billion in 1994 to over $300 billion in 1999 and 2000.[19]

Theoretically, the implications of this project extend to several literatures. First, this dissertation contributes to our understanding of globalization's influence on a nation's economy. In particular, the research illuminates how domestic interests promote and react to increasing international trade and capital flows. Second, this research has implications relevant to the emerging literature on the creation and evolution of political institutions in response to interest groups' changing political power. Third, the theoretical implications of the dissertation extend to the literature regarding state involvement in economic affairs. Finally, this project will be of immediate interest to France and Japan country specialists, to Western Europe and European Union scholars, and to those interested in industrialized nations. The implications of the research also extend to other countries and regions of the world, to developing countries, and to nondemocracies, with appropriate limitations.[20]

Research Methods

I use two different methodologies, quantitative analysis and comparative case studies, to understand why countries' financial systems vary. Quantitative analysis permits the researcher to uncover broad patterns that would not be easily decipherable from looking at a small number of cases. Moreover, statistical analysis ensures that my conclusions are representative of a wide range of cases and not just one or two that draw my attention. To test the robustness of my argument to periods of high and low levels of international trade and capital flows, I perform statistical tests across OECD countries from 1950 to 1990.

I supplement the quantitative analysis with case studies since the former permits us to draw correlations, but it is not particularly helpful in building, refining, and verifying causal theories. Moreover, case studies are important for ensuring that the conclusions I draw from the statistical analysis are not too sweeping. Indeed, cases will elucidate some of the unique ways in which particular countries translate actors' political power into financial structure outcomes. By examining specific cases, we can account for the uniqueness of particular countries' political institutions and rules (e.g., whether the country has an upper house and the extent of its power), and ascertain how these impact the types of legislation that a government passes. For example, we can survey countries' varying corporate finance laws, and how agricultural banking differs from country to country. Once legislation is passed, the cases will also show whether governments privilege different kinds of enforcement via such mechanisms as subsidized loans, directing government funds to specific industries, and restrictions on access to credit.

I examine two cases in detail: France and Japan. These cases are useful because they display a variety of interesting differences during the twentieth century although they both changed from market to banking-dominance. In particular, left-wing political power is considerably stronger in post-WWII France than in Japan.

At the beginning of the century, left-wing, small firm, and farmers' political power in France is very low compared with the post-WWII period. Although the war pushed France toward banking-dominated finance, France remained reliant on banks after the war initially because of capital scarcity, but once this subsided banks continued to dominate primarily because of the increased political power of the left, and as France pursued import substitution industrialization policies in the 50s and 60s.

In Japan, small firms, the left and farmers likewise had minimal political power in the pre-war era. The war with China beginning in 1937 moved Japan toward a greater reliance on banks, which deepened with the Pacific War. After World War II, farmers and small firms had considerably more political power; the left had very little. Japan's largest firms relied on banks after the war initially because of capital shortages, but later as a result of the country pursuing a combination of import substitution and export-oriented industrialization in the 50s and 60s, and as a consequence of the political power of farmers and small firms. Increasing openness and the economic crises of the 70s pushed both France and Japan toward a greater reliance on market-dominated finance. In France, a left-wing resurgence in the early 80s pushed her back toward banking temporarily, but the pressures of international trade and capital flows ultimately forced the Socialists to bolster the domestic securities markets.

Because there is a considerable amount of information available on these two countries, the historical research will be reliable and verifiable. Moreover, both of these countries have played central roles in the international financial system during the twentieth century, making the historical research of greater substantive interest. I should also clarify that I do not attempt to explain the emergence of capital markets; I focus on countries and time periods in which market and bank financing are viable alternatives.

Organization of the Dissertation

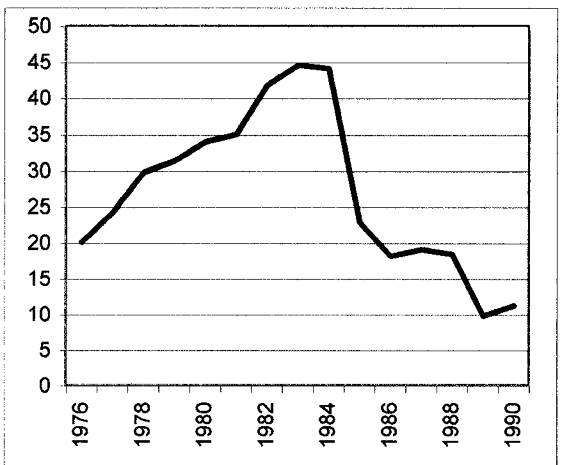
The next chapter more fully develops the theory, and lays out the hypotheses. In the third chapter, I discuss the operationalization of the variables and test the strength of the hypotheses with statistical analysis. In chapter four I examine France from 1870 to 1990. First, I provide an historical overview of the key independent variables since the late 1800s to see whether the statistical results from Chapter three hold up over a longer period of time, and to see the critical turning points in the financial system that merit closer investigation. Then, I perform detailed analysis of legislation passed during the Popular Front and the role of the labor–farmer-small business coalition. Next, I scrutinize the immediate postwar period, from 1944 to 1946 in light of labor's unprecedented political power. I also examine the 1981 to 1986 period as the Socialists initially prop up the banking system and then yield to pressure from increasing international capital mobility by bolstering France's capital markets. In chapter five I summarize how the political interests and institutions led to Japan's prewar market-oriented financial system;

then I offer a detailed analysis of the period when the financial system changed, from 1937 to 1952. Finally, I summarize the ramifications of the postwar political system for the financial system and how it differed from the prewar one. The sixth chapter evaluates the hypotheses from chapter two in light of the statistical results and the qualitative evidence, discusses some additional findings, and offers some ideas for future research.

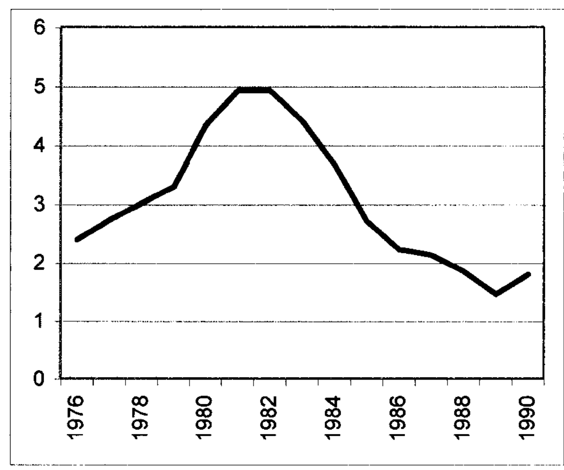
Appendix 1A: National Financial Systems, 1976-1990

The following figures illustrate the dependent variable for each country over time without the logarithmic transformation. The y-axis measures the ratio of bank assets to stock market capitalization, so a higher number on the y-axis means that the country is more banking-oriented.

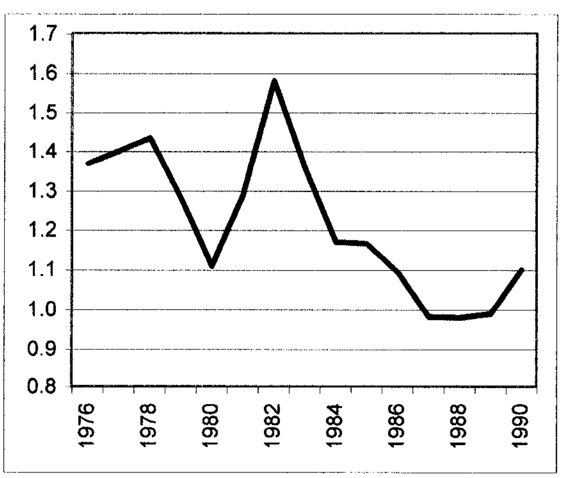
Figures 1A.1-1A.14: Bank Assets Over Stock Market Capitalization by Country (without the natural log transformation)



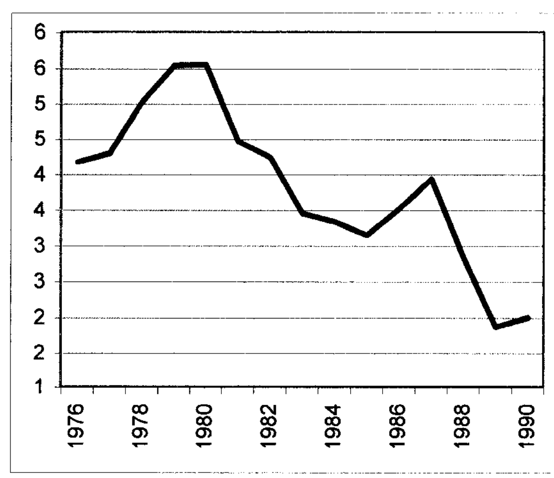
1A.1: Austria



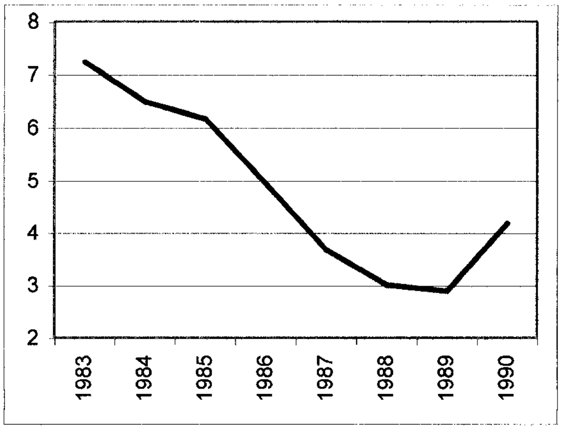
1A.2: Belgium



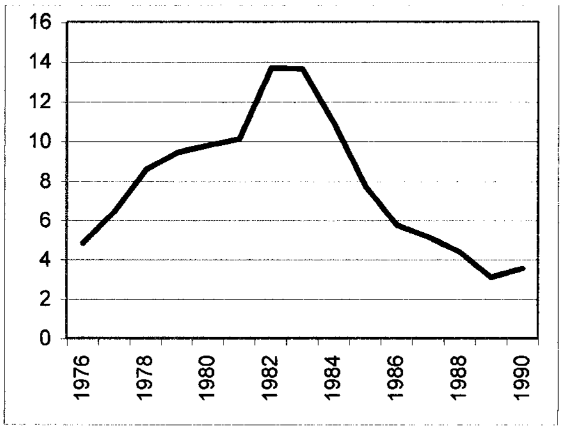
1A.3: Canada



1A.4: Denmark

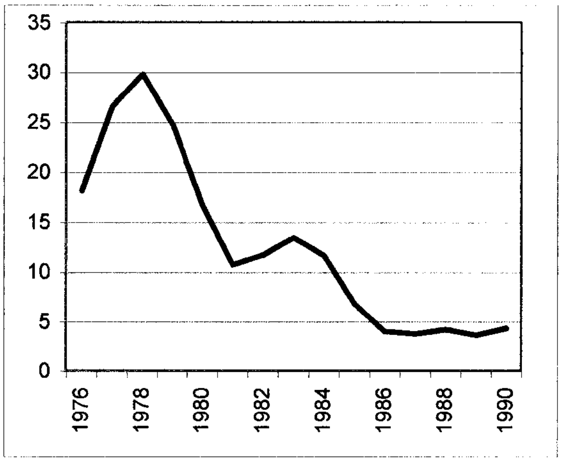


1A.5: Finland

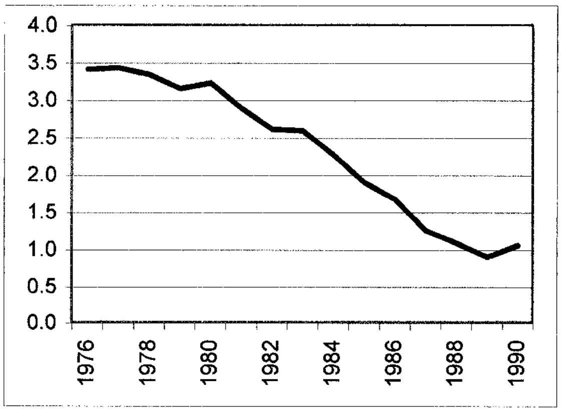


1A.6: France

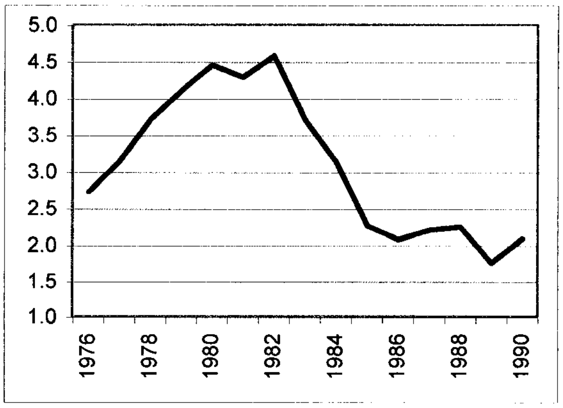
1A.7: Germany



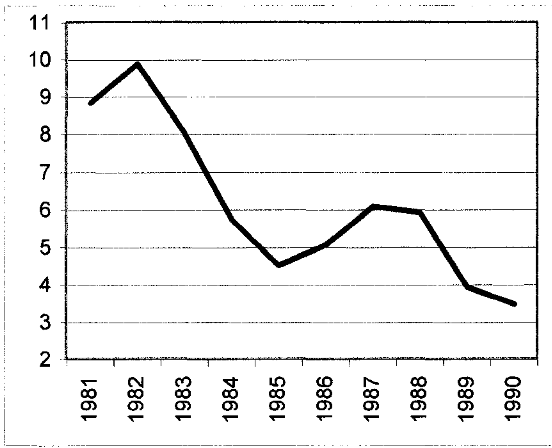
1A.8: Italy



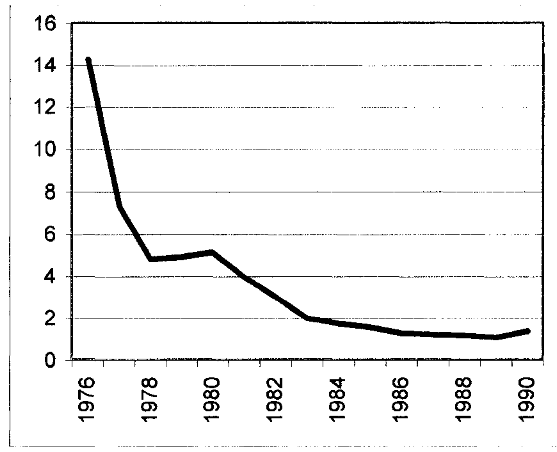
1A.9: Japan



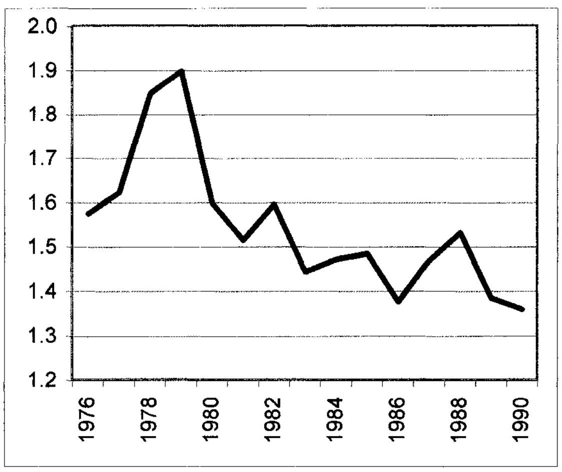
1A.10: Netherlands



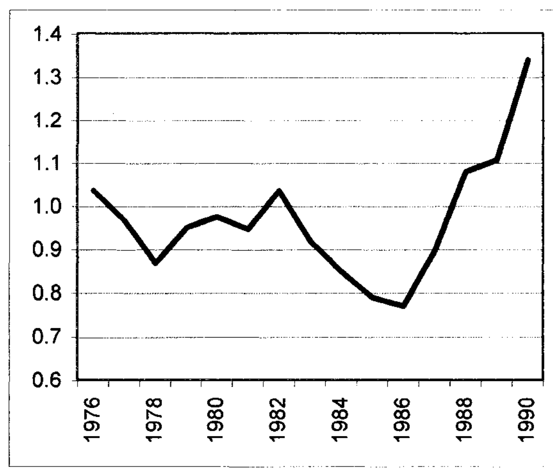
1A.11: Norway



1A.12: Sweden



1A.13: USA



1A.14: UK

[1] See Hall and Soskice (2001: 8-9) for a thorough discussion on the differences between these two capitalist systems.
[2] Williamson, 1985, discusses the role of hierarchies as well, but for this study, on focus on the market arrangements.
[3] The average ratio of bank assets to stock market capitalization in Italy was 12.7, in France 7.8, in Germany 7.2, in Japan 2.3, in the US 1.5, in Canada 1.2, and in the UK 0.9. Data are from Beck, Demirguc-Kunt, and Levine, 1999.
[4] Data for figure 1.1 is computed by taking the total assets of deposit banks relative to stock market capitalization. In order to ease comparison among the countries by reducing the nominal size of extreme measures, I take the *log* of total deposit bank assets relative to stock market capitalization. Chapter 3 explains the rationale for this particular operationalization of countries' financial systems.
[5] Because Japan has come to rely more on securities markets than many other OECD countries, authors differ in their classification of Japan as a LME or CME during the 1980s and early 1990s. But, during most of the postwar period, Japan has been known for its reliance on bank financing.
[6] Data calculated as demand deposits relative to securities (net).
[7] Hoshi and Kashyap, 2001, Chapter 1.
[8] Gourevitch and Hawes (2002) offer an excellent overview of many types of arguments concerning national production systems, which mirror the issues dealt with here.
[9] See, for example, Rajan (1999). Where information about one group of firms is better than another group, investors' money will flow to them (i.e., large firms), and away from firms with poor information availability (i.e., small firms), ceteris paribus. Large companies will have more information available because of the increased likelihood of transacting with these firms since they are more likely to require financing. This also creates greater liquidity for these firms' stocks and bonds, adding a second dimension to the attractiveness of these firms for large investors, who often want to be able to exit a position quickly and need sufficient liquidity to do so. As money flows to larger firms, supply increases and thereby lowers the cost of capital for these larger firms. In contradistinction, small firms lose their supply of capital, making the cost of capital greater. As a result, large firms will prefer the move toward markets, and small firms will prefer a banking system if it gives them more capital than the move to a market-oriented system. However, as contractual completeness improves, that is, as property rights and information technology improve, markets may make the cost of capital less for small firms than a banking system that redirects capital to the smaller firms.
[10] A proportional representation electoral system assigns seats in the legislature to parties according to the percentage of votes that each party receives across all districts. A plurality electoral system is one in which only one candidate from each district wins. Japan's Semi-PR electoral system has been a single non-transferable vote (SNTV) system until recently. In the SNTV electoral system, each voter votes for one candidate. The winning candidates are simply those with the greatest number of votes, in order, until all seats are filled. This is viewed as a method which encourages proportional representation because it tends to be an optimal strategy for a party to run a number of candidates proportional to its percentage of the vote. Then, if parties are correct in their guesses, the

results will be largely proportional. Finally, there is France's majoritarian system. In this system, the election may take place in two rounds. The first round is conducted in the same way as a normal plurality election. If a candidate receives an absolute majority of the vote, then they are elected outright, with no need for a second ballot. If, however, no candidate receives an absolute majority, then a second round of voting is conducted, and the winner of this round is declared elected.

[11] Rajan and Zingales use tariffs on imports as one way to measure openness in 1913. See Minami, 1986, *The Economic Development of Japan*, 251.

[12] See Ramseyer and Rosenbluth, 1995, 115-17.

[13] Of course, there are exceptions (e.g., large firms in financial distress), however, the statement holds generally speaking. See Hoshi (1995) for more detail on this argument and for empirical tests.

[14] See Rajan and Zingales, 2003.

[15] Note that the IMF and developed countries extract concessions from developing countries with precisely this sort of arrangement. That is, by offering incentives and disincentives to developing countries, lenders can make borrowers alter their policies and even their economic and political institutions.

[16] Chapter two offers further details.

[17] Many of the implications arising from variations in financial systems mirror those arising from variation in the overall differences among capitalist economies, and are delineated in Hall and Soskice (2001), *Varieties of Capitalism.*

[18] See Hall and Soskice (2001), Chapter One for a thorough discussion of how technological innovation varies across countries with organized market economies versus those with liberal market economies.

[19] See Credit Suisse First Boston, 2002, "2001 M&A Market in Europe: heading towards recovery in 2002."

[20] With regard to developing countries, for example, effective deposit insurance is an issue of great importance (Demirguc-Kunt and Kane, working paper).

Chapter 2

Theory

I argue that the structure of a country's financial system depends on the political power of large firms relative to that of labor, farmers, and small firms. Large firms seek cheap capital, and usually prefer to get it through markets. Labor prefers bank lending because it offers greater employment stability. Farmers and small firms prefer to divert money to themselves with banks. They also prefer banks for their informational and volatility smoothing advantages.

In this chapter, I first discuss the dependent variable. Second, I discuss international conditions affecting national financial systems by first considering the consequences of peace and war, and then whether the country is open or closed during peacetime. Next, I deductively derive actors' preferences for bank and market financing, and delineate the likely coalitions they will form. Then, I consider their political and economic power, and how institutions enhance or diminish their political power.

Financial System Orientation

In this chapter, I specify a theoretical explanation for the variation in national financial systems. Specifically, I seek to explain why some developed countries rely more on markets and others on banks. To this end, I deductively derive actors' preferences regarding banks and markets, and then consider their political and economic power.[1] By considering both the economic and political power of various actors, we must be careful about specifying the dependent variable. If we only consider the economic power of each actor, then financial system structure would be the most appropriate measure. On the other hand, if we look exclusively at the political power of various actors, then policy outcomes regarding the financial system may be more appropriate. It is reasonable, however, to look exclusively at an overall financial system measure since actors' political power influences it, with policy outcomes acting as an intervening variable. So long as we control for other economic variables influencing the structure of a country's financial system, we can discern whether actors' political power influences the financial structure.

To determine the impact of actors' political power on policy outcomes, votes on specific pieces of legislation, such as the crucial French banking law of December 2nd, 1945, will be illuminating. Close examination of the political factors leading to the passage of legislation governing the financial system will be done in the case study chapters.

Actors' political power may, however, influence the structure of the financial system through the selective use of regulatory instruments. The nature and magnitude of this enforcement may also vary *independently* of whether policy is passed. For example, if a legislature is dominated by the left, bureaucrats may feel greater pressure to use particular regulatory tools that they would not use if a right-wing party were in power, and vice-versa. For this additional reason, an overall measure of the financial system, as opposed to policy outcomes, is useful. Thus, I use financial system structure as the key dependent variable, and consider financial system policies more specifically in the case study chapters.[2]

While I am primarily concerned with the balance between banks and markets, the theory also allows hypotheses with regard to differences among national banking systems. In particular, whether we observe more small, local banking facilities depends on the political power of farmers and small firms, as will become clear later in the chapter. The nature of variation across banking systems is of secondary importance to the dissertation, but I will highlight these findings in the case study chapters as they emerge.[3]

Actors' Preferences

In this section, I first discuss the preferences of big firms and labor, and then consider the preferences of farmers and small firms. I focus on these particular actors because they wield the greatest influence over the structure of a country's financial system. Certainly, other actors may have strong preferences regarding a country's dependence on banks or markets (e.g., entrepreneurs, or banks themselves), however, few exercise the same level of influence as these groups.

Although I discuss labor and big firms separately, I acknowledge that labor is one of the key actors within a firm, along with owners and managers. Owners are either blockholders (those owning a large percentage of the enterprise, such as banks or families) as is common in banking-oriented financial systems, or they are shareholders (each owning a small fraction of the enterprise) as in capital market-oriented systems. Managers are delegated responsibility by the owner(s) to maximize profit, within given constraints. In Europe, these constraints usually come in the form of balancing profit maximization against employment stability for the firm's employees (Roe, 2002). The magnitude and variety of these constraints depend on labor's political strength and union bargaining power, and ultimately influence the financing decisions that firms make.

In large firms, owners and labor frequently have conflicting preferences over the firm's external financing arrangements; owners more likely to prefer capital markets while labor will more likely prefer bank loans. In small firms, however, the financing preferences of owners and labor are more frequently aligned; both prefer banking. Thus, I differentiate among firms in terms of their size since this is the most crucial dimension along which owners' preferences vary, and I discuss labor separately since their preferences are invariant with regard to firm size.

A brief cautionary note regarding actors' preferences must be made. It is analytically crucial, as Frieden (1999) notes, to distinguish between actors' preferences and the strategic setting in which they interact to influence outcomes. Under some circumstances we may observe actors voting for or acting in a way that privileges a different financial system from that which they actually prefer. This often occurs in a strategic policymaking arena. Because an actor's behavior incorporates both its underlying preferences and its strategic response to the setting it faces, we cannot deduce actors' preferences simply by observing them. This applies to economic circumstances as well. For example, consumers prefer the highest quality car given an equal price. If there are tariffs that make higher quality imported cars more expensive than domestic autos, then consumers will buy domestic autos not because they prefer them, but because of the economic setting they face. Simply observing the purchasing patterns of consumers does not tell us what they prefer, and will not tell us what they will do if tariffs are removed; rather, we must have some theory regarding the underlying preferences motivating their actions. Only by understanding actors' preferences can we predict their future actions as circumstances change. Thus, I pay careful attention to deductively deriving actors' preferences.

Additionally, asserting that actors prefer only banks or markets is a simplification of reality; many firms may prefer a combination of bank lending and equity financing. But the goal of theory is to explain a broad range of phenomena with a simple model of the world. The success of a theory is judged not by its ability to explain everything about the world, but by its ability to explain 'a lot with a little' (i.e., parsimony). Adding permutations to the basic theory outlined here in order to explain aspects of the world that do not conform to my theory's predictions will be explored in future research.

Big Firms

Firms want to borrow money cheaply; that is, at the lowest rate available. They can do this either by using their own internal funds, or by seeking external financing. This project looks at the external options for firm finance. There are essentially three alternatives: (1) unsubsidized loans via banks; (2) securities markets (e.g., bonds and equities); and (3) subsidized loans via banks.

In deciding whether to turn to bank lending or securities markets, firms must consider the benefits and drawbacks of each -- what are they? Economists looking at the Japanese main bank system argue that it confers four important benefits over securities markets. Main banks provide implicit insurance, overcome information and incentive problems constraining investment by market participants, reduce financial distress costs, and monitor corporations efficiently (Hoshi, 1995). While these observations are gleaned from Japan, the insights are applicable to bank-firm relationships in other countries. Germany's universal banking system, for example, is usually considered quite similar to Japan's main bank system in terms of the relationship between banks and firms (e.g., Carrington and Edwards, 1979; Charkham, 1989), and together, Japan and Germany are often considered to represent prototypical banking-based systems of finance for firms. I survey the literature on Japan's banking system as a way to understand some of the general benefits and drawbacks of bank lending relative to capital market financing. Of course, each country will vary in terms of the type and degree of these benefits and drawbacks (e.g., Dietl, 1998; Roe, 1992; Vives, 2000).

Nakatani (1984) argues that one advantage of the main bank to firms is that it can smooth out the profit of its customers by adjusting the loan rates according to cyclical fluctuations of sales and/or insulating the loan rates from fluctuations in the bank's cost of funds. Hirota (1990) tests and confirms Nakatani's argument.

With respect to the reduction of informational problems, Myers and Majluf (1984) claim that arms-length financing contracts may exhibit inefficiency, charging an excessively high interest rate to those firms with a low chance of default. Banks overcome this problem because they have good information about their customers, and will therefore not add much premium to the loan rates. Hoshi, Kashyap, and Scharfstein (1991) support this argument with their own tests.

Banks can also reduce financial distress by mitigating the informational problem and by overcoming collective action problems that occur with many arms-length creditors. "Suppose the value of the firm as a going concern exceeds its liquidation value, so that it makes sense for the creditors to forgive some debts and let the firm continue its business. Even though this makes sense collectively, any single creditor may not want to forgive [the firm's] debt…."(Hoshi, 1995) This can prevent an efficient debt reorganization from occurring. Suzuki and Wright (1985) and Hoshi, Kashyap, and Scharfstein (1990) find that evidence supports this view.

Finally, in order for banks to intervene before financial distress occurs, banks need to be informed about their customer's condition. Economists looking at Japanese keiretsu found that banks send directors to a firm when that firm's performance deteriorates (e.g., Kaplan and Minton, 1994; Morck and Nakamura, 1992; and Sheard, 1994b). By doing this, the bank can anticipate better the likelihood of future financial distress and make appropriate adjustments.

Despite all of these benefits to firms who rely on bank financing, recent data shows that many large Japanese firms started reducing their dependence on bank loans in the late 1980s (Hoshi, Kashyap, and Scharfstein, 1995). Firms sought alternative financing arrangements primarily because of higher transaction costs: the cost of monitoring makes bank financing more costly compared with other unmonitored financing such as financing through corporate bond issues or selling equity.

However, Hoshi, Kashyap, and Scharfstein (1995) also find that some firms decided to stay with bank financing even if other ways of financing were available, suggesting that the benefits of relationship banking outweigh the costs for at least some firms; but which firms and why? The benefits of a banking relationship may outweigh the costs because of the insurance mechanisms available through a banking relationship, which are most useful during periods of economic distress. Smaller firms that lack diversified profit streams are most likely to encounter cash flow shortfalls. Larger, diversified firms are more likely to successfully endure periods of economic distress. Because big diversified firms are more likely to have good credit ratings, they are more likely to find arms-length financing cheaper than bank loans. Additionally, larger firms would be the object of closer scrutiny by large institutional investors who seek sufficient liquidity to buy and sell financial instruments, thereby leading to more efficient financing, ceteris paribus. Indeed, Hoshi (1995) finds that large Japanese firms with good credit ratings are more likely to increase their reliance on arms-length financing than smaller firms or big firms with poor credit ratings over the 1980s and 1990s period. Thus, large firms are more likely to turn to arms-length financing because of the lower transaction costs, ceteris paribus.[4]

Markets can be of further benefit because they allow greater managerial autonomy since managers generally have greater freedom as a result of a highly fragmented ownership pool (Vogel, 1978). Securities markets also facilitate the creation of powerful incentive-based pay schemes for managers, benefiting both them and the owners (Roe, 2002). Indeed, the benefits of arms-length financing may even outweigh the lower cost financing available from *subsidized* bank lending.

Lending that is subsidized by the government is more likely if it does not have to worry about balance of payments equilibrium, which is possible when international trade and capital flows are low. Commonly, governments will assist their domestic industries with ISI or EOI (import-substitution industrialization or export-oriented industrialization) policies when they are uncompetitive in world markets. Subsidized loans to favored firms were common following WWII as nations sought to rebuild basic industries. For countries devastated by the war, maintaining a closed economy offered protection for their 'infant industries' until they were ready to compete in the global marketplace. In the prewar era, by contrast, Japan had a relatively closed economy but did not worry about having to rebuild its domestic industries; consequently, firms relied on market financing whether tariffs were high or low. Thus, subsidized loans are more likely in an environment of low international trade and capital mobility, and when large firms are relatively uncompetitive in comparison to other countries' large firms in the home country's main markets.[5]

H1: large firms are more likely to receive subsidized lending via banks when: (1) large firms are uncompetitive in their main foreign markets; and (2) international trade and capital flows are low.

As Gourevitch (1986) has shown, the level of openness is determined by domestic actors' preferences. In industrialized nations, with capital-intensive industries, large firms will press for trade liberalizing policies so that they can fulfill their comparative advantage potential. Realizing that this may place strains on their ability to get subsidized loans from the government, large firms must decide whether the greater revenue from freer trade exceeds the cost of forgoing subsidized loans. At some point, it is. During periods of high trade and capital mobility, certain firms and industries may continue to receive subsidized lending, however, the amount will be far smaller and less likely to have a sizeable impact on the structure of the overall financial system. As international capital mobility increases, and the supply of subsidized lending declines, firms will seek financing from securities markets. If domestic markets are not adequate or as competitive as foreign markets, then large firms will sell equity and bonds abroad, forcing the home government to bolster its domestic markets to keep their financing business.

For example, as a result of the 1973 oil crisis, the Japanese government (via MITI) began reducing the level of its subsidies to favored firms (Johnson, 1986). Because firms could get lower interest rates in the Euromarkets than from unsubsidized bank loans for their external financing needs, Japanese banks started to change their activities from lending to market-makers (Rosenbluth, 1989). In other words, because Japanese banks could not make competitive loans to firms, they decided to attract the firms to Japanese capital markets by starting a new viable business as brokers and underwriters. In this context, international trade and capital flows can place pressure on the government to enhance their securities markets in ways that are *external* to the governance structure of corporations.

International trade and capital mobility can also place pressure on the government to modify its corporate governance rules, and thereby alter incentives for using specific forms of financing which are *internal* to the firm. Specifically, certain rules and corporate structures permit owners to raise capital more quickly and at lower cost than other corporate structures. For example, France signed treaties promoting freer trade with Britain and Belgium in 1857 and 1862, which had more liberal laws for organizing a corporation (i.e., it was faster and less costly to raise capital on the stock exchanges since they did not need the consent of government). Consequently, many French businesses started relocating and reorganizing their corporations under the legal jurisdiction of these other countries. This forced France to liberalize its own corporate governance rules for its Sociĕté Anonymes with the law of 1867. The initial result was an immediate rise in the creation of Sociĕté Anonymes from an annual average of 14 for the period 1842-1866 to an average of 219 per year for the period 1868-1878. Consequently, the annual fluctuations of the formation of SAs correlated with the fluctuations on the Bourse, with a one-year lag. This lag is accounted for by the time it took to plan and to promote an SA.

The ease with which SAs could be founded sustained the boom of the late 1870s and early 1880s. A distinguishing feature of this boom, according to Freedeman (1993), was the central role played by Parisian and regional stock exchanges.

Thus, increasing international trade and capital mobility place pressure on a country to bolster its domestic capital markets and affiliated financial services, and may also force the government to liberalize its corporate governance laws. Because Rajan and Zingales (2003) hypothesize that increasing international trade and capital flows correlate with a greater reliance on securities markets, I offer an extension to their argument. Specifically, I hypothesize:

H2: Increasing international trade and capital flows bolster national securities markets via mechanisms that are external *and* internal to the firm.

Internal mechanisms focus on corporate governance structures, while external mechanisms focus on market-enhancing mechanisms outside the firm (e.g., competitive broker fees, investment banking services, balance-of-payments equilibrium, etc.). In this regard, Rajan and Zingales focus their conjecture on the external mechanisms.

But it is crucial to point out that we will still observe banking or market-dominance across countries when international capital and trade flows are high *or* low. Higher levels of international trade and capital flows simply *constrain* the spread of the bank-market orientation across countries.

Labor

Labor seeks high and stable employment rates, along with reasonably high and stable wages, and a generous supply of social welfare services (including guaranteed health care, unemployment insurance, disability insurance, free public education, etc.). Left-wing political parties also consider these among their highest priorities; thus, I discuss these preferences with regard to labor, but left-wing political parties also seek to fulfill these objectives. There are two mechanisms by which labor pursues these ends: (1) *direct* control over credit allocation via government owned and operated banking institutions, and/or (2) *indirect* control by regulating financing arrangements in the marketplace. The second option occurs with legislation and bureaucratic pressure on private firms, the private banking sector, and the capital markets.

One way for labor to achieve its social welfare goals is to own the means of production; that is, to nationalize the most important, if not all, corporations. Of course, owning and efficiently operating all corporations through the government can be an extremely complex task, likely doomed to failure. A simpler method for pursuing the aforementioned goals is through the control of finance. By controlling the amount of money available to key industries, the interest rate at which credit can be extended, and by offering additional incentives and conditions for extending credit to particular firms and industries, labor can effectively pursue its more specific objectives. The control of credit permits labor to extract concessions from firms' owners and managers.[6] Banks, or intermediaries generally speaking, are the preferred institutional mechanism for controlling credit since markets do not permit precise, selective inducements to specific firms and industries. Thus, labor prefers bank-dominated financing as an external mechanism for achieving its employment, wage, and social services objectives.

During the postwar period, for example, left-wing politicians initially manipulated corporate lending through France's largest banks, which were nationalized in 1945 (Crédit Lyonnais, Société Générale, Banque Nationale pour le Commerce et l'Industrie, and Comptoir National d'Escompte de Paris), by administering preferential terms of refinancing and subsidies to targeted loans. Additionally, during the first twenty years following the war, lending was further manipulated with a system of rediscounting bank loans. From the late 1960s to the early 1980s, ceilings on the amounts a bank can loan were used to control finance in France. When a bank pushes beyond allotted limits, the price at which it can refinance the loans by borrowing funds from the central bank is prohibitive and additional lending is thus constricted. Exceptions to these credit ceilings have been granted for favored loans (Zysman, 1983: 129-30).

Labor also seeks to influence corporate financing through indirect means; that is, by allowing private actors to borrow and lend in a decentralized marketplace, but to encourage bank lending at the expense of arms-length finance. Labor favors bank financing because it is longer-term, and thereby provides greater employment stability. During the business cycle, for example, firms are likely to lay off employees when an economic downturn ensues if there are no commitment mechanisms for keeping workers employed (e.g., contractual obligations with unions, or workers wield sufficient power on the board of directors). Long-lived intermediaries offer firms a financing mechanism by which to smooth the volatility associated with capital markets, and thereby reduce fluctuations in employment.[7] When firm financing depends primarily on equity finance, workers are usually the first to lose their jobs as cost-cutting measures are pursued to protect corporate profits. Thus, bank financing protects workers from this bleak alternative.

For example, in post-World War I Japan, when labor was tight, skilled workers often changed jobs.[8] An economic downturn in the 1920s led to a surplus of labor, and "employers were ready to fire when business was slow, and seniority was no guarantee of exemption. To the contrary, they more often fired the older worker with seniority, but very likely declining skills as well. Throughout the decade, management fired workers and reduced work-force size."[9] Recall from figure 1.17 that Japan was dominated by arms-length financing at this time. After World War II, however, lifetime employment emerged, and was supported by the banking dominated financial system.[10]

Additionally, bank lending's long-term nature encourages firms to invest in more firm-specific human capital (Soskice and Iversen, 2001). Since firms cannot easily replace their workers with employees from other industries, managers have an incentive to retain them through a downturn in the economy. But we have to be careful about the causal direction: do workers cause the shift to bank financing or does long-term financing lead to firm-specific employee skills? Roe (2002) discusses this with regard to Germany and finds that blockholding emerged first. However, labor may seek to preserve this arrangement to ensure employment stability. Examination of legislation suggests that labor bolsters firm reliance on bank lending with regulations affecting corporate governance structures (giving labor more influence on firm financing decisions), and related areas including accounting transparency, managerial incentive compensation, and hostile takeovers (Roe, 2002). I briefly discuss each in turn.

With regard to corporate governance structures, Great Britain and the United States are at one end of the spectrum, where stockholders have the strongest influence over managers' decisions. "At the other end is Japan, where managers' expressed goal is to pursue employment stability for workers rather than dividends for shareholders" (Allen and Gale, 2000). Germany and France are intermediate cases, where the interests of shareholders are pursued in conjunction with those of employees.

The corporate governance structures of the United States and Great Britain are designed so as to permit shareholders greater influence. They generally have 10 to 15 board members, where a majority are typically from outside the firm for US firms, while in the UK, a minority are.

In Japan, however, the size of boards is much larger than in other countries, with the overwhelming majority of directors coming from inside the company. In Germany, firms with more than two thousand employees have two boards: the supervisory board and the management board. The supervisory board is the controlling body, with half of its representatives elected by shareholders and half by the employees (Schneider-Lenne, 1992; Prowse, 1995). The management board is appointed by the supervisory board. Finally, France permits the choice between single-tiered boards, like the Anglo-American model, or two tiers, as in Germany. However, with either choice, workers' representatives have the right to attend board meetings as observers in all companies with at least fifty employees.

With regard to accounting, a lack of transparency makes arms-length monitoring more difficult. This forces owners to be closer to the firm to overcome the informational inadequacies, thereby privileging blockholders who use longer-term bank financing.

While lack of transparency may not have originally arisen with the emergence of labor political power, as Roe (2002, 41) remarks, it may be sustained by left-wing governments because it encourages employment stability.

Incentive compensation that would tie managers more closely to the interests of shareholders (e.g., options) is discouraged in continental European nations because it would reduce managers' concern for employee interests. Roe (2002, 43) remarks, "In Germany and Sweden, stock 'options are not considered entirely ethical', presumably because managers there were expected to represent all of the firm's constituencies, and stock options would bind them tightly to one of them."[11]

Labor also views hostile takeovers with disdain. Takeovers usually occur when an entrepreneur or manager at another firm thinks that he can improve the target firms' operations, and thereby profit. To this end, layoffs are almost a certainty as the new owner seeks to cut costs and eliminate positions already performed by the takeover firm. In social democratic countries, hostile takeovers are uncommon (Roe, 2002, 43-46).

In summary, labor seeks to influence credit allocation in order to achieve its employment, wage, and social services objectives. Direct control over firm financing offers greater power than indirect control, and we would expect it to emerge when labor has overwhelming political power. For example, during the postwar period, Austria, Italy, France, and the Scandinavian countries have all had nationalized banks for substantial periods of time while Germany, Belgium, Switzerland and the Netherlands, have relied more on indirect control (e.g., Zysman, 1983 and Katzenstein, 1985).

H3a: Higher levels of labor political power will lead to more banking-oriented financial systems.

H3b: Higher levels of labor bargaining power will lead to more banking-oriented financial systems.

Farmers[12]

For the purposes of this study, farmers can be reasonably divided into two groups: small farms and corporate farms. Small farms are very similar to small firms with regard to financing preferences, and likewise for corporate farms and large firms. During most of the twentieth century, corporate farms were rare, however. It is only in the last quarter of the twentieth century that we really saw their emergence, and primarily only in the United States and Canada (with regard to the 14 countries in my sample). Thus, it is more reasonable to discuss farms in terms of their being like small firms.[13]

One of farmers' highest priorities is cheap financing. As economies industrialize and modernize, markets allow capital to flow to those growing industries that offer the highest rate of return with regard to risk. This reduction in the supply of agricultural finance raises its cost. Accordingly, farmers prefer policies that divert money to the rural sector, and away from industry.[14] To do this, banking institutions are necessary. While small firms would surely also prefer that money be diverted away from large firms, they are far less capable of accomplishing this since they cannot organize themselves as effectively as farmers, generally speaking. For this reason, farms get financing institutions that differ from the bank financing that serves small firms. Specifically, we often see farmers' cooperatives, or other types of banking institutions designed specifically to cater to farmers.

Secondly, banks are willing to provide much-needed financing in difficult times because of the long-term nature of their relationship. This helps to smooth out the volatility associated with changes in seasonal weather patterns and uncertain crop yields. This is especially important to farmers since their ability to diversify among different crops and livestock is limited.

Third, banks, and especially small banks, are more likely to have sufficient information about farmers to determine the appropriate rate at which to provide them with financing. Without a high level of information, a risk premium would have to be charged to compensate for the increased risk of making a loan. Indeed, markets are likely to charge farmers a higher rate than banks for this reason, ceteris paribus. This results from a collective action problem (or free-rider problem) since no one investor is willing to invest the time and effort to investigate every farmer, thereby creating a higher risk premium. Thus, farmers prefer small, local banks insofar as they have an informational advantage.

H4a: Increasing farmer political power will lead to a more banking-oriented financial system.

H4b: Higher levels of agriculture's contribution to the GDP will correlate with more banking-oriented financial systems.

Small Firms

Like farmers, small firms prefer banks because of their insurance services (reducing volatility) and informational advantages. Specifically, bank financing can help small firms weather a cash flow shortfall, which is more likely to occur with small firms than big firms because of their undiversified product line. Additionally, shareholders are unlikely to invest the time to investigate a small firm since their financial instruments (bonds or shares) lack the liquidity they desire. Banks can overcome informational problems for small firms if they are in the local community and familiar with the local businesses that market participants would have much higher costs obtaining information on.

H5a: Increasing small firm political power will lead to a more banking-oriented financial system.

H5b: Higher proportions of the GDP deriving from small firms will correlate with a more banking-oriented financial system

Coalitions and Cleavages

Large firms seek cheap capital, and so their first preference is for subsidized loans via banks, otherwise they prefer markets to unsubsidized loans via banks because markets have lower transaction costs. Labor prefers bank lending because it offers greater employment stability. Farmers seek to reduce their financing costs by redirecting capital to the rural sector via banks. Farmers and small firms also prefer banks because of their informational and volatility smoothing advantages.

Labor, farmers, and small firms share a general preference for banking finance. We may therefore see them act together regarding broad regulations governing the financial system, and to bolster banking services generally speaking. For this reason, it is important that we look at a broad measure of the financial system. With regard to specific aspects of the financial infrastructure such as corporate governance and agricultural cooperatives, they are likely to act separately.

H6: The combination of labor, farmer, and small firm political power will have a stronger correlation with banking-dominance than the political power of each group alone.

As important as a coalition among these actors is the likelihood of a coalition between big firms and labor.[15] A straightforward consideration of their preferences suggests that big firms and labor are likely to form a coalition when subsidized loans are available, which is more likely when international trade and capital mobility are low and when firms are uncompetitive their main foreign markets. However, labor itself may vary in terms of its support for subsidized loans. Specifically, labor that works in the firms receiving the subsidies may prefer them, but labor not employed by these firms will likely be opposed since they will have to pay for the subsidies without receiving any of the benefits. Further splits in labor may occur along religious lines, where Catholics may be more supportive of business interests and more inclined to vote for centrist or moderate right-wing parties while secular labor may vote for more left-wing parties, such as Socialists and Communists.

While farmers and small firms share several reasons for preferring banks, they also diverge in important ways as well. Specifically, farmers differ from small firms because their financing needs are seasonally determined, because they can more easily form highly organized peak associations, and because they may seek to regulate the futures market. Thus, the variety of intermediation services they desire, and the consequent banking institutions that arise, will differ.

Additionally, labor and farmers also differ in terms of the specific types of banking services they seek. Labor is primarily interested in the financing arrangements of large corporations, and therefore seeks to influence corporate governance regulations and to influence corporations by controlling the terms under which they can obtain credit/financing. Farmers primarily want cheap capital by diverting it away from industry (and other sectors) toward the rural sector. Farmers also want banks that can obtain good information about them, that offer long-term financing arrangements to insure against the uncertainty of seasonal weather patterns and crop yields, and to regulate the futures market in order to establish a floor price and to ensure price stability. Thus, both farmers and labor prefer banks, though for different reasons. Their divergent preferences will also lead to different forms of banking services and institutions.

Extensions: Sectors and Religion

It should again be stressed that the preferences delineated here are simplifications of reality. Future work would usefully consider permutations on this theory. For example, we might consider whether firms in different sectors prefer different forms of financing. Since capital markets are better for financing technological breakthroughs (Hall and Soskice, 2001), high-tech industries such as biotechnology or electronics may have a stronger preference for markets. Industries that primarily invest in incremental innovations, such as engines or consumer goods, may prefer bank financing.

Additionally, religion can play an unexpectedly crucial role with regard to labor (Gourevitch, 1986; Gourevitch, 2003). Specifically, the extent of labor's affiliation with the Catholic Church may cause a sharp cleavage among workers—those voting for Socialists or Communists, with others voting for more centrist or moderate right-wing parties. For example, this was particularly important to de Gaulle's presidential victories, which influenced the types of policies that he could implement given the Catholic workers in his electoral base.

Political Power and Institutions

Large firms influence politicians primarily via their financial contributions and ability to exit the country in search of financing. They have little influence in terms of their voting power though. For farmers, small firms, and labor, votes constitute the primary means of influencing legislators. Accordingly, we must consider how political institutions enhance or diminish the political influence of these actors; that is, whether the political institutions privilege money or votes. Additionally, farmers, small firms, and labor may exert influence on the financial system with their economic power; by this I mean agriculture's and small firms' contribution to the national economy and labor's bargaining power independent of its political representation.

How do actors influence policy outcomes?

Farmers are concentrated geographically, which makes them a potent force since political representation is usually drawn along geographical lines (i.e., with districts). Also, they tend to have similar preferences across a large number of policy dimensions, which facilitates their political mobilization. Because they do not represent a large proportion of the population, farmers' parties are rare. However, the fact that farmers can clearly influence policy decisions (e.g., agricultural subsidies, and tariffs) illustrates their political importance.

Labor is also capable of overcoming collective action problems. Because labor tends to have similar preferences across a wide range of issue areas, can organize itself into a peak association, and often represents a significant proportion of the population, it can be politically powerful. Labor's political power also varies across countries, with political institutions playing a key role.

Big firms (owners and managers in particular) influence government with their money and by retaining an exit option when international trade and capital mobility are high. Variation in political institutions, and electoral systems in particular, can impact the influence of big firms with regard to the extent that money influences election outcomes, and with respect to the degree to which opposing political actors get proportionately more or less political power. With Japan's multi-member single nontransferable vote (SNTV) system, for example, money makes a considerable difference for candidates' reelection efforts, and candidates depend on campaign contributions from big business. Below, I discuss exactly how the multi-member SNTV electoral system creates this exacerbated dependence. In countries with proportional representation electoral systems, labor representation is magnified, which thereby reduces big firms' political power.

Small firms can certainly play an important role politically when elections are extremely close and this small group of voters can tilt the balance either way.[16] However, this group of voters generally represents a small portion of the total voting population. For example, if we observe the distribution of the French work force employed in industrial plants with over ten employees, there is a very small proportion in the smallest category.

Table 2.1: Labor and Firm Size in France, 1906-1966

Number of persons in the plant	1906	1926	1931	1936	1954	1962	1966
11-20	12%	10%	10%	10%	8%	8%	8%
21-100	28	28	27	27	28	28	29
101-500	31	30	30	30	31	32	33
500+	29	33	33	33	33	32	30
Totals	100	100	100	100	100	100	100

Source: M. Didier and E. Malinvaud, "La concentration de l'industrie s'est-elle accentuée depuis le début du siècle?" Economie et statistique (June 1969), p. 7. Reproduced in Berger and Piore, p. 95.

While the workers of these small firms may have preferences that differ in some ways from those in large firms, their voting habits are likely quite similar on many dimensions as well. For this reason, their voting power may be picked up already by the measures for labor's political power and bargaining power. Additionally, many small firms in the 'traditional' sector (a term commonly used to describe small firms) are also farms; thus, a measure for farmers will also pick up a good portion of these small firms. Finally, we can note that in France in the 1970s, the number of votes controlled by small, independent property holders and their families falls between 3 and 4 million (a measure used by Berger and Piore, 1980, to estimate the size of the traditional sector's electorate). This represents about 7 percent of the total population, much of which, however, is already accounted for by the rural population. Therefore, I focus on how political institutions influence the representation of farmers, labor, and big firms for the large-n analysis, and give more attention to small firms in the case studies.

Enforcement of Legislation

Once policy is passed, it still requires the political will to enforce it, which also depends on the political power of groups in government. Prominent mechanisms of enforcement involve the legal system, government influence on labor-firm negotiations, the establishment and maintenance of agricultural cooperatives and other financial institutions, as well as subsidized loans and interest rates and the supply of government funds for specific uses. Ideally, a measure for the bank-market orientation of the financial system would be broad enough to capture the changes in money flows to banks and markets resulting from these multiple methods of enforcement. But to ascertain the extent of actors' political power, we need to account for how institutions magnify or diminish their representation in government.

Political Institutions

Given that we are dealing with stable democracies, three particular attributes of political institutions matter because of their respective impact on the political power of these actors: (1) the extent of *interparty* diffusion which refers to whether the electoral system permits the representation of many parties, as in proportional representation systems, or few parties, as in plurality systems; (2) the extent of *intraparty* diffusion which considers whether the electoral system is candidate-centered or party-centered; and (3) the extent of district-level *malapportionment*, which primarily affects farmers' political power. There is no question that other aspects of countries' political systems also impact actors' political power (e.g., veto-gates), however, parsimony forces us to privilege those attributes of political systems with the greatest explanatory power across industrialized democracies. In the case studies, I will examine how unique political institutional arrangements in each country affect actors' political power.

Interparty diffusion leads to two ideal types with plurality electoral systems at one end and proportional representation systems at the other. Plurality systems privilege the median voter as two parties compete for 50% + 1 of the popular vote. This generally forces both parties toward the middle of the political spectrum, creating large, catch-all parties. Consequently, narrower interest groups who depend on votes for their primary means of political influence tend to either have their ideal policies diluted in strength as they associate with a political party that appeals to the middle of the political spectrum (e.g., labor), or they do not have any political representation at all (e.g., green parties) (Olson, 1982). In proportional representation systems, however, these groups are more likely to be represented, and consequently these systems generally lead to stronger labor representation in government (Katzenstein, 1985, pp. 150-170 and Cox, 1990). Thus, I come to the following corollary:

H3a': Countries with proportional representation electoral systems will have higher labor political power, and will therefore be more banking-oriented.

I label this H3a 'prime' because the electoral system itself does not alter the structure of the financial system. Rather, it is a corollary of the hypothesis regarding the more banking-oriented consequences of increasing labor political power. For example, electoral systems magnify or diminish the political power of certain groups over others only when these groups constitute a nontrivial proportion of the population. For example, if labor and farmers did not exist, then a country with a proportional representation electoral system would not privilege that group. This is a fairly obvious, but important assumption to make explicit since labor lacked political power at the beginning of the twentieth century in most countries. Thus, the extent of interparty diffusion would not impact their political representation, as we will see in the case study on France.

Other factors play important roles in determining labor's political influence too, which help to explain the variation in labor's political power among countries with the same electoral system. Katzenstein (1985) argues that these are tied to the history of the country, including whether the nation has a feudal past, the timing of its industrialization, as well as ethnic, linguistic, and religious divisions.

Intraparty diffusion refers to the extent to which the electoral system privileges candidates over political parties (Shugart and Wattenberg, 2001). In candidate-centered systems, politicians seek to build and maintain their personal reputation, which usually requires that legislators garner large sums of money from private sources in order to dole out 'pork' as a means of ensuring voter loyalty. This leads legislators to cater to organized blocs of voters in their districts such as small firms and farmers, and to ignore the interests of consumers and the public good. Japan, up to the electoral reforms of 1993, was the prototypical case (Reed and Thies, 2001). Italy, up to its reforms in 1993, was another highly candidate-oriented nation (D'Alimonte, 2001). In these cases, we would expect politicians to have a greater incentive to cater to the financing preferences of big firms in exchange for their campaign funding contributions, and to bolster banking facilities for small firms and farmers.

Party-oriented systems tend to be less responsive to constituents. In these systems, individual legislators have less incentive to curry favor with voters since they vote for a party, and not for particular candidates. Consequently, the party leadership becomes powerful since it decides how to distribute seats among its members, and is largely unaccountable to the general public. During times of economic prosperity this system may function adequately. When a downturn in the economy occurs and groups seek greater political influence to cushion their hardship, calls for electoral reform may occur, as occurred in Venezuela in 1984 (Crisp and Rey, 2001). Financially powerful interests may get access to party leaders, but most groups do not. Generally speaking, however, more party-oriented systems that do not experience 'hyper-centralization' as in Venezuela tend to favor the public good more than candidate-centered systems. Systems where constituents vote based on party and candidate reputation balance the tendency toward pork-barreling with the need for more public-oriented goods in order to maintain a positive party image. Consequently, we would expect fewer banking institutions catering to small business and farmers in non-candidate-centered electoral systems. I do not offer a corollary of a hypothesis here since the case study time periods do not exhibit any changes with regard to this dimension.[17] I save such a test for future work.

Following conventional wisdom, I assume that the primary reason for malapportionment is the difference in population densities between urban and rural areas, where urban areas will have a higher vote to seat ratio than rural areas. The deviation from the appropriate vote to seat ratio (i.e., zero malapportionment) reflects the proportion of the population that is overrepresented in rural areas, and underrepresented in urban places. Looking at how malapportionment is calculated makes this clear: take the absolute value of the difference between each district's seat and population shares, add them, and then divide by two.[18] Thus, the formula is:

$$\text{Malapportionment} = (1/2)\ \Sigma|s_i-v_i|$$

where sigma stands for the summation over all districts i, s_i is the percentage of all seats allocated to district i, and v_i is the percentage of the overall population (or registered voters) residing in district i. The following example illustrates how to apply the formula.

Table 2.2: Malapportionment Example

	District			
	1	2	3	4
%v	40	30	20	10
%s	36	24	23	17

For each district, the deviation from perfect apportionment is the difference between the district's shares of seats (s) and votes (v). To calculate overall malapportionment for the four districts, we first add the absolute values of the differences between seats and votes for each district. We then divide the total by two. In this case Malapportionment=(1/2)(|36-40| + |24-30| + |23-20| + |17-10|)=10%. This score means that ten percent of the seats are allocated to districts that would not receive those seats if there were no malapportionment.

Lijphart (1999) provides support for the use of malapportionment as a measure of rural overrepresentation: "The main cases of malapportionment have had to do with rural overrepresentation: for instance, the United States (until the reapportionment revolution of the 1960s), Australia and France (until about 1980), Japan under the SNTV system, Norway until 1985, Iceland from 1946 to 1959, and Spain." Many other authors support the use of malapportionment as a way of gauging the overrepresentation of rural interests in Japan (e.g., Mulgan, 2000; Wada, 1996; Thies, 1998), the U.S. (McCubbins and Schwartz, 1988; Butler and Cain, 1992), Australia (Jackman, 1994), and France (Cotteret, Emeri, and Lalumiere, 1960).

Malapportionment matters most with respect to the lower house of the legislature, since this is likely to favor rural interests less than the upper house yet is equally important in passing legislation, generally speaking. Thus, it acts as a higher barrier for rural interests in terms of support.

H4a': Countries with more malapportionment will have more banking facilities for farmers.

Appendix 2A: Formalizing the Argument

I model the conditions under which the government will support bank or market finance with a Stigler-Peltzman regulation framework when firms face a choice between unsubsidized loans and financing via securities markets. Within the Stigler-Peltzman framework, households seek lower prices while firms seek to maximize profit with rising prices. However, if prices become too high, demand will contract and profits will decline. From the firm's perspective, the optimal price is that which maximizes profit (i.e., monopoly). From the consumers' perspective, low prices are best, which implies perfect competition. The government decides where to set regulation so that it is somewhere between monopoly and perfect competition, based on its desire for money, from firms, and votes, from consumers.

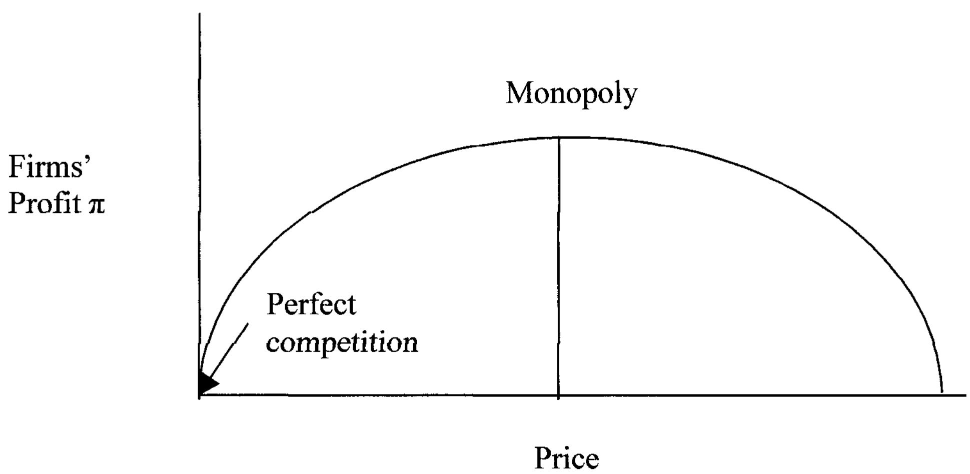


Figure 2A.1: Stigler-Peltzman Firm Profit-Price Trade-off

The Stigler-Peltzman framework is useful for thinking about the trade-off between politicians' desire to accommodate the desires of big firms, who seek a capital-market oriented financial system, and farmers and labor, who desire a banking-dominated one. The following figure illustrates the trade-off. Notice that big firms' preference for capital markets is matched with a flatter slope while farmers and labor preference for a banking-oriented system coincides with a steeper slope.

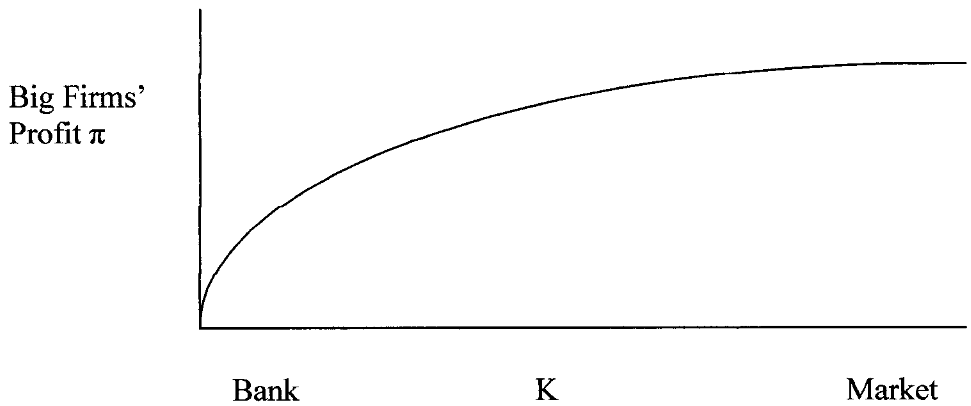


Figure 2A.2: Big Firms' Profit and Financial System Trade-off

I assume that the government cares about two things: (1) legislative support, denoted by L; and (2) campaign funds, or money, from supporters, denoted by M. Farmers and labor influence government with their legislative support, while large firms and farms contribute campaign funds. I take farmers to also comprise small firms.

The trade-off between large firms' financial support relative to farmers' and labor's electoral support can be modeled with a Cobb-Douglas function:

$$S = M^{\alpha}L^{1-\alpha} \mid \alpha \in (0,1) \qquad (1)$$

Total government support is denoted by S. Legislative support – the share of seats in the legislature for each voting group (farmers and labor) – is a function of vote share V, i.e., $L = L(V)$, $\partial L/\partial V>0$. Labor's and farmers' support (in votes) decreases with a more capital-market oriented financial system K. Big firms' support will increase with profits. Formally, we have

$$V = V_F(K) + V_L(K)$$
$$\text{where } \partial V_L/\partial K < 0, \text{ and } \partial V_F/\partial K < 0 \qquad (2)$$

$$M = M_B(\pi) + M_F(K),\ \partial M_B/\partial \pi > 0, \text{ and } \partial M_F/\partial K < 0 \qquad (3)$$

Where V_F denotes vote share from farmers, and V_L vote share from labor. M_B denotes the money from big firms and M_F money from farmers.

Substituting (2) and (3) into (1), we have

$$S = [M_B(\pi) + M_F(K)]^{\alpha} [L(V_F(K) + V_L(K))]^{1-\alpha} \tag{4}$$

With this equation we can derive the marginal rate of substitution (MRS),

$$d\pi/dK = - (\partial S/\partial K) / (\partial S/\partial \pi) \tag{5}$$

where,

$$\partial S/\partial \pi = \alpha(M_B(\pi) + M_F(K))^{\alpha-1} (\partial M_B/\partial \pi) L^{1-\alpha} \tag{6}$$

and

$$\partial S/\partial K = \alpha(M_B(\pi) + M_F(K))^{\alpha-1} (\partial M_F/\partial K) L^{1-\alpha} + (M_B(\pi) + M_F(K))^{\alpha} (1-\alpha)L^{-\alpha}(\partial L/\partial V)[\partial V_L/\partial K + \partial V_F/\partial K] \tag{7}$$

With some rearranging of terms, the marginal rate of substitution can then be stated as $\partial\pi / \partial K$ =

$$- \frac{1\text{-}\alpha/\alpha \ \{[(\partial L/\partial V)/(L(V))][\partial V_L/\partial K + \partial V_F/\partial K]\}/\{1/[M_B(\pi)+ M_F(K)]\}+ \partial M_F/\partial K}{\partial M_B/\partial \pi} \tag{8}$$

The comparative statics revealed by (8) fit with intuition. First, notice that as farmers' monetary support becomes more responsive to changes in the structure of the financial system ($\partial M_F/\partial K$ grows more negative), there is a steeper positive slope. Additionally, there is greater labor and farmer voting power (more banking-oriented financial system) and a steeper slope as:

1) labor and farmer votes become more responsive to changes in the structure of the financial system ($\partial V_L/\partial K$ and/or $\partial V_F/\partial K$ grows more negative).

2) politicians weight votes (as opposed to money) more heavily (decreasing α, hence increasing $1- \alpha$); or

3) politicians already have more monetary support (higher M_B and/or M_F).

Conversely, large firms have more influence on government policy leading to a flatter slope when:

1) large firms' monetary contributions become more responsive to profits (rising $\partial M_B/\partial \pi$)
2) politicians weight money more heavily (larger α) or
3) the government already enjoys higher levels of legislative support (L).

Finally, the curve becomes steeper, therefore more banking-oriented, as seats-votes elasticity ($\partial L/\partial V$) increases. However, this number is a function of the type of electoral system, where proportional representation systems translate into more labor political power, and higher levels of malapportionment increase farmers' political support. We can use Taagepra and Shugart's (1989) observation that virtually every extant electoral rule can be approximated by a power function of the form

$$L_i = V_i^{\tau} / \Sigma_1^N V_i^{\tau} \qquad (9)$$

Where V_i is the ith party's vote share and L_i is the same party's share of parliamentary seats. In systems of proportional representation, τ approximates one by design. In plurality single-member district systems, something like a "cube rule" prevails, i.e., $\tau \cong 3$. Using Olson's logic and Katzenstein's observation (1986) that labor becomes more politically powerful in proportional representation systems, labor's seat to vote share will approximately equal $1/\tau$.

With regard to farmers, their influence increases as malapportionment (mal) increases, holding their proportion of the population(i.e., vote share) constant. Incorporating labor and farmers vote to seat shares into the elasticity function, we have

$$\partial L/\partial V = \partial L_L/\partial V_L + \partial L_F/\partial V_F = (1/\tau) + \text{mal} \qquad (10)$$

And substituting into (8) we have $\partial\pi/\partial K$ =

$$- \frac{1-\alpha/\alpha \; \{[((1/\tau) + mal)/(L(V))][\partial V_L/\partial K + \partial V_F/\partial K]\}/\{1/[M_B(\pi)+ M_F(K)]\}+ \partial M_F/\partial K}{\partial M_B/\partial\pi} \quad (8a)$$

This implies that as τ increases, labor political power decreases. As malapportionment increases, farmer's political power increases. These will lead to a more banking-oriented financial system as the slope becomes steeper.

[1] Frieden, (1999) discusses the importance of deriving actors' preferences deductively, as opposed to gleaning them from observation or assuming them.
[2] I use a measure for the overall financial system, as opposed to one exclusively for firm-financing or household assets since farmers and labor have preferences regarding both of these, and will exercise their influence over both. That is, farmers and labor are also households, in addition to small firms (in the case of farms) or having influence on firm financing (in the case of labor's negotiations with large firms). Households prefer bank financing since they can intertemporally smooth the volatility inherent in financial markets and increase their welfare (see chapter 6, Intertemporal Smoothing, of Allen and Gale, 2000). Future work may usefully look at these financial system measures separately.
[3] For more on the political sources of variation in banking systems, see Verdier, 2002, *Moving Money*.
[4] As noted in chapter one, as contractual completeness improves--that is, as property rights and information technology improve-- the cost of capital via markets may become sufficiently low that small firms may turn to markets for a portion of their external financing. For example, smaller firms are finding it financially attractive to seek external financing through the Nasdaq. This is a relatively recent phenomenon, and not generally applicable across all of the OECD countries, nor for the time period examined in this study.
[5] Another less common condition under which large firms may receive subsidized loans is during periods when the supply of capital is scarce relative to demand. If capital is scarce, the government must step in to determine how it will be allocated. To do this, banks are needed. In a capital scarce environment, big firms prefer intermediaries since money is funneled to them at a rate lower than that which would be available through capital markets. And as this implies, smaller firms rather than large ones tend to lose out when funds are distributed in a capital scarce environment (e.g., Calder, 1988). For example, in the pre-WWII era, Japan's largest industries did not face severe capital shortages in high or low tariff times, and continuously depended on market finance. However, immediately following WWII, Japan, and even the British government, relied heavily on banks to allocate scarce funds according to national priorities. France and Germany also followed suit.
[6] This is same argument used by neo-imperialist accounts regarding the conditions under which loans are extended to developing countries by the IMF, and the developed countries.
[7] While Allen and Gale (2000) make this argument with regard to households, the logic applies to labor's financing preferences too, since they seek the stability offered by long-lived intermediaries.
[8] See Gordon (1985, p. 87).
[9] Gordon (1985, pp. 139-40).
[10] Roe (2002) discusses the correlation between banking dominated corporate governance (i.e., a low separation of ownership) and employment stability.

[11] Quote from Peter Goldstein, 'Managers and Managing: Compensation Packages for Executives Aren't All Alike—Base Pay Converges in Europe, but Bonuses and Stock Options Vary', Wall St. J. Eur., 22 Dec. 1998, at 4.

[12] The literature on farm financing that I surveyed is framed solely in terms of banks; there is no real mention of farms seeking financing from capital markets. For example, see Calomiris, 2000; Vittas and Caprio, 1997; Neff and Ellinger, 1996; Featherstone, 1996; Ellinger, 1994; Neff, Dixon, and Zhu, 1994; Siles, Hanson, and Robison, 1994. Also see Verdier (2001) for further corroboration.

[13] See Calomiris, 2000, for further elaboration on how farmers may be broken down into different subgroups (e.g., large, wealthy versus small, poor farmers) and their preferences regarding different kinds of banking institutions (e.g., unit banking versus interstate banking in the United States).

[14] Also see Verdier (2001).

[15] One might postulate that Heckscher-Ohlin factor-based coalitions may arise, or Ricardo-Viner sectoral-based coalitions may emerge. However, these theories apply only to international trade, which differs from actors' financing preferences. For example, in the Heckscher-Ohlin model, the abundant factor (land, labor, or capital) seeks free trade. Labor may prefer free trade, but this does not mean that it also prefers capital markets, which frequently emerge as a result of high international trade and capital flows. Rather, labor will seek to mitigate the employment volatility that emerges with globalization and the concomitant move to markets (and this indeed happened in the 1920s as Polanyi, 1944, discusses). In the Ricardo-Viner model, as labor acquires more specialized skills, it aligns with firms in its particular sector with regard to free trade to take advantage of its comparative advantage. Again, however, this does not mean that labor then prefers capital markets since they are still vulnerable to the volatility of market swings. One could make the argument that the firm becomes more interested in long-term banking finance since it favors the firm-specific skills of its workers—but this clearly has not happened as globalization as increased.

[16] See Berger and Piore (1980), chapter 4.

[17] Japan does change its electoral system in 1993, which would permit a test of such a hypothesis (e.g., (H4 & H5)': highly candidate-centered systems will cater more to small firms and farmers and these groups will therefore have more of the banking institutions that they prefer). Since the current study ends in 1990, I cannot offer a test for this hypothesis.

[18] This explanation is based on the discussion of Samuels and Snyder (2001).

Chapter 3

Quantitative Analysis

In this chapter, I examine quantitative evidence using data for 14 OECD countries across the 1976-1990 period, and for the years 1950, 1960, and 1970 to test most of the hypotheses and corollaries from the prior chapter. Some are not tested here since it would be too time-consuming to properly operationalize the variables (H1, H2, H4a', H5a, and H5b). Time would be better spent focusing on tests directly relating to the core argument: the structure of national financial systems depends on the political power of large firms, who usually prefer markets, relative to the political power of labor, farmers, and small firms, who usually prefer banks. Thus, I save assessment of these non-operationalized hypotheses and corollaries for the case studies.

To briefly summarize the results, I find that the interaction of left-wing and rural political power has a potentially greater impact on the structure of a country's financial system than international capital mobility during the 1976-1990 period, where increases in left-wing and rural political power correlate with more banking-oriented financial systems. This correlation is very strong in 1970, slightly weaker in 1960, and weak but still significant in 1950, periods of relatively low international capital mobility. Additionally, the interaction of left-wing and rural political power plays a bigger role in proportional representation countries than in countries with a plurality electoral system. Left-wing political power appears to play a more influential role than rural political power across all fourteen countries, and is even more influential in countries with proportional representation electoral systems. International capital mobility also has more influence on proportional representation countries, which is likely due to these countries' smaller economies and greater sensitivity to the international economy. Finally, labor's bargaining power appears to be more influential in countries with plurality electoral systems. Rural economic power does not appear to be influential.

In the first part of this chapter, I consider how to operationalize the variables by first discussing the dependent variable, followed by the key explanatory variables, and then the control variables. The second part of the chapter proceeds to the statistical analysis. Here, I perform cross-section time-series statistical analysis on the entire sample data set (the 14 OECD countries from 1976-1990), and then for countries with proportional representation electoral systems (9 OECD countries). To clearly depict the relationship between the key independent variables with the dependent variable, I offer illustrative diagrams. Third, I examine whether the correlations observed in the foregoing section holds up during years of lower international capital mobility: 1970, 1960, and 1950. Finally, I conclude with a brief review of the statistical results. In the appendices, I check the robustness of the statistical results with sensitivity analysis across space and time, I consider alternative measures of the dependent variable, I display some additional regression results, and I perform unit root tests.

3.1 Operationalizing the Variables and Correlations

I will first discuss the dependent variable and then proceed to the independent variables, providing figures illustrating the correlation between the key explanatory variables and the dependent variable.

3.1.A Dependent Variable

The goal is to create a measure that reflects the overall bank-market orientation of a country. To this end, I seek a measure that captures the extent to which money flows through banks or markets. The measure needs to be a broad one that compares banks generally speaking to markets since farmers and labor both prefer banks, but differ in terms of the specific type of bank financing they prefer.

Moreover, a broad measure is preferable to one for narrower segments of a country's financial system, including financing of nonfinancial enterprises or gross assets owned by households, since labor and farmers act not only as groups interested in firm financing, but also as households. Future work that separates firm financing from households is the next logical step.

Beck, Levine, and Demirguc-Kunt (1999) construct a conglomerate index in order to compare financial systems across countries with varying levels of development. They argue that, "There is a major shortcoming with existing comparisons of market-based versus bank-based financial systems; they focus on a very narrow set of countries with similar levels of GDP per capita, so that the countries have very similar long-run growth rates." Because this study considers only OECD countries, I prefer to use the widely accepted 'size' measure of bank-market orientation, which measures the ratio of bank assets as a proportion of GDP to stock market capitalization as a proportion of GDP. It is more useful to use this ratio than to simply use each variable on its own for the following reason. An increase in the money supply would likely lead to a rise in bank assets, however, the increase may also lead to increased investment in the capital markets. The only way to determine whether more money goes to banks or markets is to look at a ratio of the two.

The data for the dependent variable are from Beck, Levine, and Demirguc-Kunt's database. They are available across all countries from 1976-1997 except for Norway and Finland, for which the series starts in 1981 and 1983, respectively. The variable used in the regressions is the natural log of the ratio of domestic bank assets over stock market capitalization.[1] I use the natural log to account for changing levels of variance over time.

3.1.B Independent Variables

I present the independent variables of interest for my hypotheses, followed by the variables that I will control for.

Rural Political Power: An ideal measure would be the proportion of legislators who represent rural interests. This may be possible to ascertain for individual countries, but far more difficult and time-intensive if we seek a large cross-sectional time series data set. Thus, I turn to an alternative measure that captures the extent of the rural population's political power. To this end, I use the size of the voting population in rural areas, and then account for the degree to which political institutions magnify (or reduce) their influence. The key political institution is malapportionment, which I discuss below.[2]

To derive a rural political power index, let us first assume that the rural and urban populations are equal, and assign each a value of 1. Additionally, let's vary malapportionment, going from 0% to 100%. As is common in the field, I assume that malapportionment favors the rural population. So, with 0% malapportionment, there is an equitable distribution of seats with respect to votes from the rural and urban areas. An increase of 5% malapportionment causes a redistribution of 5% of the seats from the urban to the rural area, and likewise with respect to increasing levels of malapportionment. With 100% malapportionment, all votes from the urban area will go to the rural area (this is theoretically impossible since it requires that nobody live in the district receiving the seat share, but it serves to illustrate the logic and robustness of the results). Thus, I derive a distribution for urban and rural seats with respect to the size of the original voting population. To calculate the proportion of total seats that go to the rural area, I take the number of rural seats and divide it by the total seats available. The following table illustrates the logic:

Table 3.1A: Rural Political Power

Urban Vote	Rural Vote	MAL (%)	Urban Seats = urban vote - urban vote * MAL	Rural Seats = rural vote + urban vote * MAL	Rural Power = Rural Seats/Total Seats
1	1	100	0	2	1
1	1	90	0.1	1.9	0.95
1	1	50	0.5	1.5	0.75
1	1	20	0.8	1.2	0.6
1	1	10	0.9	1.1	0.55
1	1	5	0.95	1.05	0.525
1	1	0	1	1	0.5

If we are given values for the rural population (e.g., some percent as is commonly available from census data) and for the average level of malapportionment, we can determine rural political power. Because the proportion of the population living in urban areas is simply one minus the rural population, we can derive a formula using only the rural population number. The following table illustrates the method and the formula.

Table 3.1B: Rural Political Power

Rural Pop. = rural vote/total vote	**Rural Political Power = Rural Pop. + (1-Rural Pop.) * MAL**
0.5	1
0.5	0.95
0.5	0.75
0.5	0.6
0.5	0.55
0.5	0.525
0.5	0.5

Note that the numbers from the rural political power column in table 3.1B match those of the rural power column in table 3.1A. To check that this formula holds across varying levels of urban and rural populations, we can use additional examples. Below, I increase the proportion of the urban to rural population to 2:1, then 3:1, and finally 99:1, mirroring the trend toward increasing urbanization over time.

Table 3.1C: Rural Political Power

Urban Vote	Rural Vote	MAL (%)	Urban Seats = urban vote - urban vote * MAL	Rural Seats = rural vote + urban vote * MAL	Rural Power = Rural Seats/ Total Seats	Rural Pop. = rural vote/total vote	**Rural Political Power = Rural Pop. + (1-Rural Pop.) * MAL**
2	1	100	0	3	1	0.333	1
2	1	90	0.2	2.8	0.9333	0.333	0.933
2	1	50	1	2	0.666	0.333	0.666
2	1	20	1.6	1.4	0.4666	0.333	0.4666
2	1	10	1.8	1.2	0.4	0.333	0.4
2	1	5	1.9	1.1	0.3666	0.333	0.366
2	1	0	2	1	0.333	0.333	0.333
3	1	100	0	4	1	0.25	1
3	1	90	0.3	3.7	0.925	0.25	0.925
3	1	50	1.5	2.5	0.625	0.25	0.625
3	1	20	2.4	1.6	0.4	0.25	0.4
3	1	10	2.7	1.3	0.325	0.25	0.325
3	1	5	2.85	1.15	0.2875	0.25	0.2875
3	1	0	3	1	0.25	0.25	0.25
99	1	100	0	100	1	0.01	1
99	1	90	9.9	90.1	0.901	0.01	0.901
99	1	50	49.5	50.5	0.505	0.01	0.505
99	1	20	79.2	20.8	0.208	0.01	0.208
99	1	10	89.1	10.9	0.109	0.01	0.109
99	1	5	94.05	5.95	0.0595	0.01	0.0595
99	1	0	99	1	0.01	0.01	0.01

This method is relevant for districts that are comprised of both urban and rural areas, where many districts may be semi-urban or semi-rural. In these cases, the malapportionment measure would still favor the more rural districts, but there would likely be lower malapportionment as the population becomes dispersed more evenly across districts. Additionally, I should note that in my sample of 14 OECD countries, malapportionment only varies between 0 and 10%.

Rural Population: I take the country's rural population relative to that country's entire population. The data are from a database compiled by the Food and Agricultural Organization of the United Nations. I use the rural variable since most of those working and living in rural areas depend on agricultural industries for their livelihood, and would therefore adopt the same preferences. For example, an insurance salesman living in a rural area would prefer that farms are successful so he can continue to sell them insurance. The data are available across all countries in my sample for the 1961-1999 period.

Malapportionment of the Lower House: As discussed in the first chapter, I use malapportionment for the lower house, since this is a higher hurdle for agricultural interests to surmount (in general). One could try using upper house malapportionment, but this poses a problem in that not all countries have upper houses. Moreover, the power accorded to upper houses varies considerably across those countries which have them. Thus, for theoretical and empirical reasons, lower house malapportionment is used. I refer the reader to the second chapter for a more thorough discussion of this variable's construction. The data are from Samuels and Snyder (2001). There is an important limitation for this variable, however, which is that the lower house malapportionment measures are available for only one year in the 1990s, and this year is not the same across all countries. Consequently, there is no temporal variance. Further work in this area will hopefully permit inclusion of malapportionment changes over time.

A potential problem with using a malapportionment measure for the entire country is that farmers may be located primarily in one or a few districts (e.g., Australia), making a countrywide malapportionment measure too high. However, land-intensive industries (e.g., ranches) resemble farms and small businesses in the sense that they are more likely to prefer banks. Thus, the malapportionment measure is appropriate even if it does not capture purely farmers' interests, but rural interests generally speaking.

The following figure illustrates the correlation between rural political power (using a 0-100 scale instead of a 0-1 scale) and the structure of countries' financial systems (using the natural log of the dependent variable to facilitate comparison) for the 1976-1990 period. In the following figures depicting correlations between the independent variables and the dependent variable, hollow shapes represent countries with plurality (or majoritarian) electoral systems, solid shapes are assigned to countries with proportional representation systems, and the star is for Japan's semi-pr electoral system.

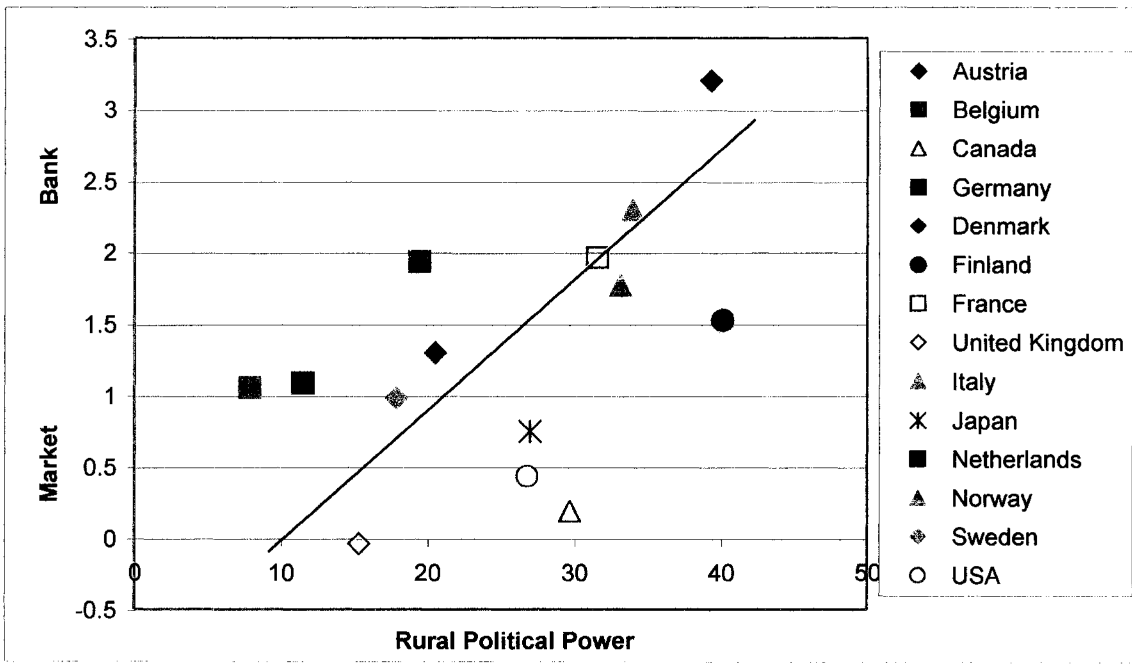


Figure 3.1: Rural Political Power and the Financial System, 1976-1990

Table 3.2: Bank-Market Orientation and Rural Political Power

DV: ln(Bank Assets/Stock Market Cap.)

Rural Political Power	0.044* (2.037)
constant	.196 (.335)
N	14
Adj. R-squared	0.195

Note: t-statistic in parentheses
* significant at the 10% level.

As hypothesized (H4a), there is a clear positive correlation between rural political power and bank-market orientation of the financial system. The correlation is not as strong as the following figure depicting labor's political power. This is likely for one of a couple reasons: (1) the malapportionment data is taken only from the 1990s and therefore does not accurately depict rural political power over the 1976-1990 period; (2) there is simply a weaker correlation on this dimension. This will be explored in more depth in the case studies.

Left-Wing Political Power: As discussed in chapter two, we must use a measure of left-wing political power rather than a pure labor political power measure. The problem that emerges with this measure is that left-wing political parties depend on the votes of groups other than labor, thereby diluting labor's political influence. However, it is the best we can do, and accounting for the placement of the political party on a left-right scale helps to account for the 'dilution' of labor's influence on the party.

The construction of this variable is explained by Garrett (1998), who says that, "The balance of political power indicator is derived from the influential expert survey by

Francis Castles and Peter Mair (1984) on the placement of parties on a left-right scale. The balance measure weights center, left, and right party groupings by their shares of legislative seats and cabinet portfolios. The balance of power in cabinet governments delineates the direct control of different families of parties over the instruments of economic policy. The legislative measure indicates the broader political constraints under which governments operate. On both variables, high scores denote a shift to the left in the balance of political power. The data are effectively bounded by mainstream social democratic/labor parties (the British Labour party, the German Social Democratic party, etc. are scored as “2”) and conservative parties (the Republican party in the United States, the Liberal Democratic party in Japan, and so forth, are scored as “0”). Centrist parties such as the Free Democratic party in Germany – and by the convention of comparative parties research, the U.S. Democrats – are coded as “1”” (p. 59). The data are available annually across all countries in my sample, from 1966-1990. Figure 3.2 illustrates the correlation between the left’s political power and the financial system.

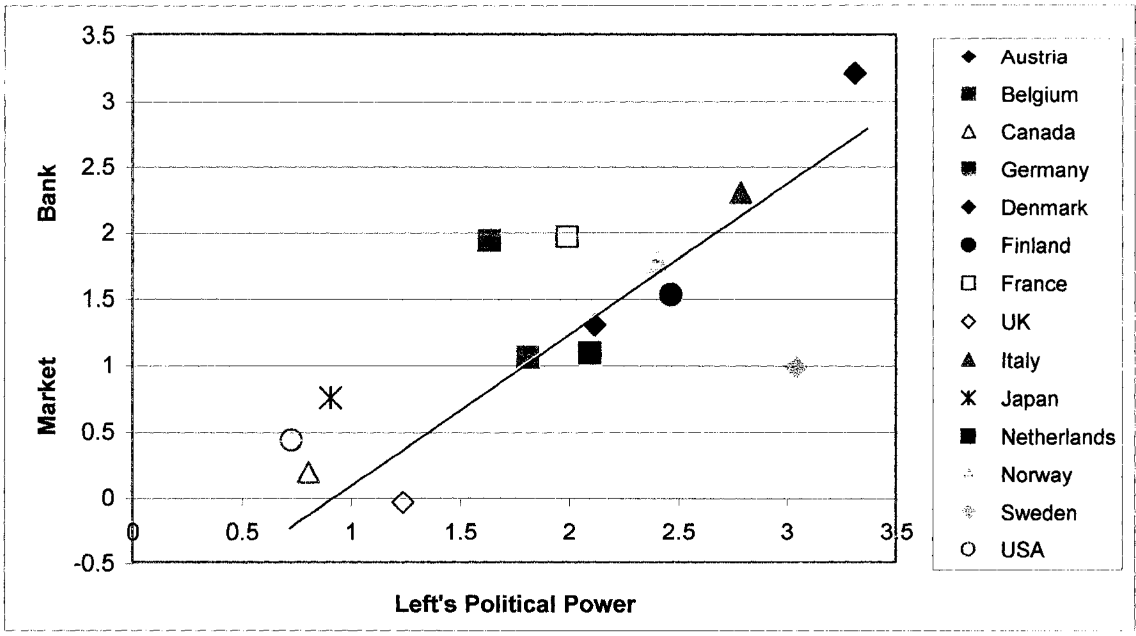


Figure 3.2: Left's Political Power and the Financial System, 1976-1990

Table 3.3: Bank-Market Orientation and Left Political Power

DV: ln(Bank Assets/Stock Market Cap.)

Left Political Power	0.819*** (4.084)
constant	-.27 (-.654)
N	14
Adj. R-squared	0.54

Note: t-statistic in parentheses
*** significant at the 1% level.

There is a very strong, positive correlation, supporting the hypothesis (H3a) that higher levels of left-wing political power correlate with more banking-oriented financial systems. Also, note that countries with proportional representation are more abundant in the upper-right quadrant, while countries with plurality electoral systems (and Japan's semi-pr system) are in the lower left, as asserted with the corollary (H3a'). France is a notable exception, but is theoretically reasonable if the left is so strong that it surmounts the 50% threshold necessary in plurality (majoritarian) systems.

Left-Rural Political Power: I interact the left and rural political power variables since their combined influence matters more than their independent effects. That is, since both groups seek to bolster the use of banks, it is necessary to combine their political power. Moreover, rural interests frequently votes for right, making it necessary to combine them with the left to accurately account for the total pro-banking coalition. This measure will indicate the level of political support for passing policies in favor of banking, and for the enforcement of these policies. To see whether these groups form coalitions, we need to look at specific policies, which will be done in the case studies.

It would be preferable to have a measure for the proportion of legislators representing each group and then to add these together (assuming that there isn't any overlap/double-counting). Failing that, however, the next best solution is to interact the measures. Double-counting can be reasonably avoided since labor tends to reside in urban areas. Figure 3.3 illustrates the correlation between this measure and the financial system.

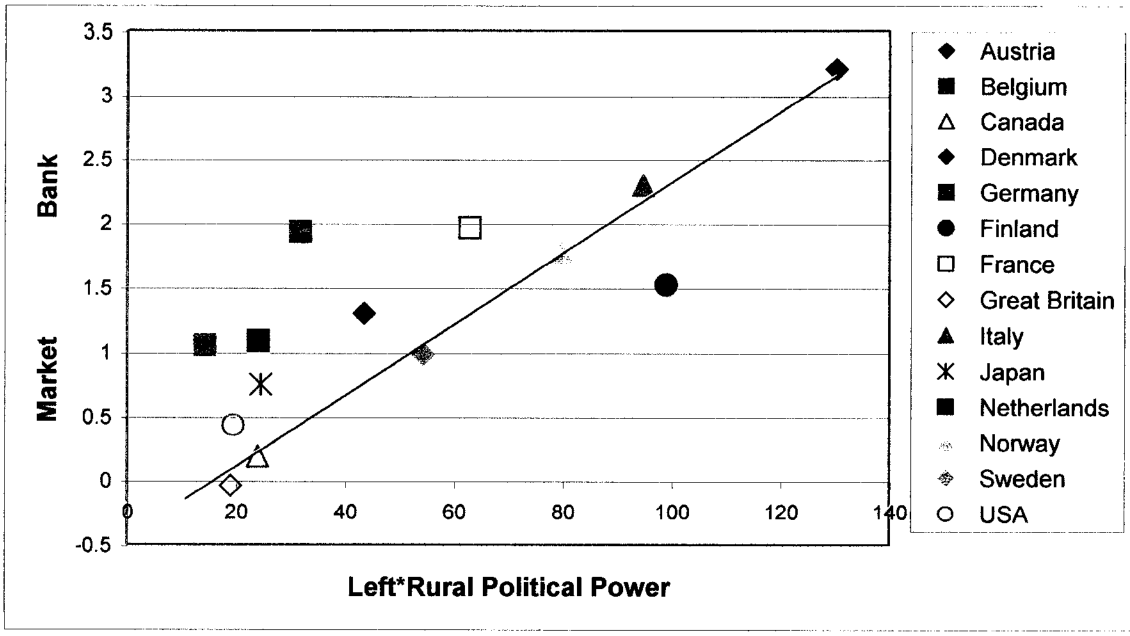


Figure 3.3: Left*Rural Political Power and the Financial System, 1976-1990

Table 3.4: Bank-Market Orientation and Left-Rural Political Power

DV: ln(Bank Assets/Stock Market Cap.)

Left-Rural Political Power	0.019*** (5.008)
constant	.29 (1.2)
N	14
Adj. R-squared	0.64

Note: t-statistic in parentheses
*** significant at the 1% level.

The strong, positive correlation between left-rural political power and the bank-market orientation of the financial system supports the core argument (H6). Notice that it is stronger than the correlation for left political power; the t-stat is higher and the adjusted R-squared is also higher, supporting the hypothesis that the combination of labor and farmer political power has a stronger correlation than the political power of either group on its own.

Labor's Bargaining Power: This variable is also constructed by Garrett (1998) and is called 'labor market institutions.' He explains that the encompassment of labor market institutions "[increases with] union density and major confederation share, but [decreases] in public sector share and the number of confederation-affiliated unions (i.e., standardized scores for density and major confederation share, minus standardized scores for public sector share and affiliates)" (Garrett, p. 67). Union density measures the number of union members relative to the size of the labor force (Visser, 1991). Major confederation share measures the proportion of all union members belonging to the largest confederation of labor unions. Public sector share indicates the proportion of all union members employed in the public sector. The data are available annually across all countries in my sample, from 1966-1990. Figure 3.4 shows the correlation between labor market institutions and the financial system:

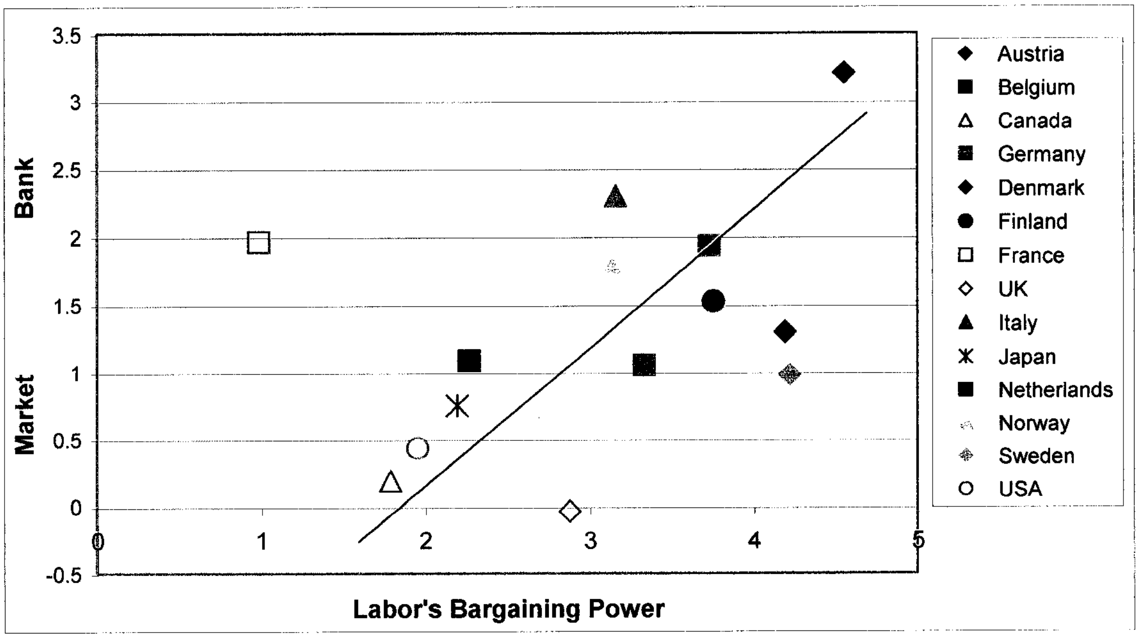


Figure 3.4: Labor's Bargaining Power and the Financial System, 1976-1990

Table 3.5: Bank-Market Orientation and Labor Bargaining Power

DV: ln(Bank Assets/Stock Market Cap.)

	All Countries	France Excluded
Labor Bargaining Power	.34 (1.58)	.637*** (2.86)
constant	.27 (.39)	-.75 (-1)
N	14	13
Adj. R-squared	0.1	.37

Note: t-statistic in parentheses
*** significant at the 1% level.

Notice the strong, positive correlation, as hypothesized (H3b), when France is excluded. France is a clear outlier, suggesting that left-political power may be a better explanation than labor bargaining power; the case study will be illuminating.

Agriculture's proportion of GDP: This is simply a measure of a country's GDP that comes from agriculture. The data source is the World Bank's Macro Time Series dataset. Figure 3.5 shows the correlation with countries' financial systems:

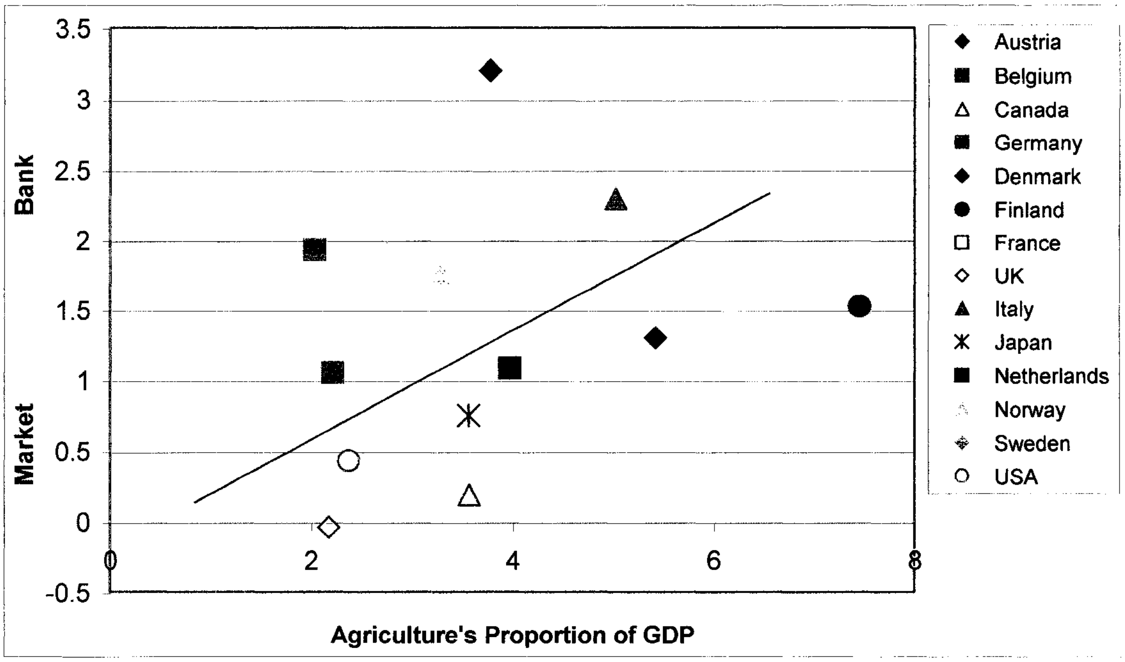


Figure 3.5: Agriculture's Proportion of GDP and the Financial System, 1976-1990

Table 3.6: Bank-Market Orientation and Agriculture's Proportion of GDP

DV: ln(Bank Assets/Stock Market Cap.)

Agricultural GDP	.176 (1)
constant	.64 (.98)
N	14
Adj. R-squared	0.01

Note: t-statistic in parentheses.

There is a loose, positive correlation here, but the scatter of the variables suggests that rural economic power may have little explanatory value in comparison to the other variables, as suggested by the regression results. Thus, the hypothesis (H4b) that agriculture's economic power correlates with more banking-oriented financial systems, is very weakly supported.

International Capital Mobility: Since the openness of a country is very much a consequence of political maneuvering (Gourevitch, 1986; Rogowski, 1989), and may be correlated with actors' preferences for domestic banks or markets, I seek a measure that is exogenous to the influence of domestic politics. Accordingly, I use a measure of international capital mobility constructed by Sinn (1992), which uses savings and investment data to determine cross-sectional capital mobility for each year.[3] Intuitively, this measure can be thought of as the opportunity costs to big firms for not participating in global capital markets as international capital mobility increases. The data are available for the period 1860-1992, from Taylor (1996). The actual capital mobility indicator is a coefficient, where a smaller coefficient indicates higher capital mobility. To make the interpretation more intuitive so that a higher number indicates higher capital mobility, I transform it by taking 1 over the coefficient.

A potential drawback of this measure is that it is partially endogenous to countries with large financial systems (e.g., the US) becoming more capital market-oriented. However, it is not as problematic as taking the capital mobility of each particular country. Moreover, it is less endogenous than an alternative measure for large firms, namely the concentration of large to small firms. Countries that are more banking-oriented have a much higher concentration of large to small firms relative to market-oriented countries and this is largely determined by the structure of the financial system.

Control Variables

Legal Systems: La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1996, 1999) argue that civil law systems will be more banking-oriented than common law systems. Their results show that common law countries generally have the best, and French civil law countries the worst, legal protection of investors, with German and Scandinavian civil law countries located in the middle. Accordingly, I control for the type of legal system in each country by assigning a dummy variable to each legal system across countries, leaving out the English common law variable.

GDP per capita: Rajan and Zingales (2003) argue that increasing industrialization increases that country's reliance on capital markets. Thus, I include this variable. It is real GDP per capita data from Penn World Table 5.6.

Openness: Rajan and Zingales (2003) also argue that increasing openness leads to the development of capital markets. Because of potential endogeneity reasons, as cited with respect to the discussion about the international capital mobility variable, they also use tariffs. However, this is just as likely to be endogenous. Since they use this term to interact with the GDP per capita variable, I will use it to replicate their tests. The data for this variable ((exports + imports)/GDP) is from the Global Development Finance and World Development Indicators database. Rajan and Zingales also use a variable which interacts GDP per capita, openness, and international capital mobility, however, the last variable is coded as simply 1, if low mobility, or 0, if high, in their analysis. The period I test would be coded 0 in their analysis. Thus, I do not perform a three-way interaction.

Banking Concentration: To control for the potential power of banks to influence financial structure, I add a banking concentration measure as a proxy for banks' power, under the assumption that a more concentrated banking sector will be able to overcome collective action problems more easily. These data are from Beck, Demirguc-Kunt, and Levine's (1999) dataset on financial structure and are measured as the ratio of the three largest banks' assets to total banking sector assets. Because these data are only available for the 1990s, I take the earliest measure available for each country, usually 1990, and use this for the 1976-1990 period for each country.

Table. 3.7: Descriptive Statistics

Independent Variable	Observations	Mean	Standard Deviation	Minimum	Maximum
Left*Rural Political Power (LRPP)	198	49.2	37.4	1.48	140
Left's Political Power (LPP)	198	1.9	0.96	0.05	3.57
Rural Political Power (RPP)	198	24.6	9.5	7.2	40.7
Labor's Bargaining Power (LBP)	198	2.98	1.05	0.4	4.74
Agriculture/GDP (AGDP)	192	3.6	1.43	1.5	8.7
International Capital Mobility (MOB)	198	1.48	0.2	1.26	2.04
Banking Concentration (BankC)	198	0.55	0.232	0.23	0.92
(Imports+Exports)/GDP (Open)	198	60.5	28.4	16.8	146.6
Natural log of GDP per capita (GDPcap)	198	9.4	0.15	9.07	9.8
Interaction of Openness and natural log of GDP per capita (GDPcap*Open)	198	568.4	265.25	161.4	1367
German legal system (German)	198	.23	.42	0	1
French legal system (French)	198	.3	.46	0	1
Scandinavian legal system (Scandinavian)	198	.24	.43	0	1

3.2 Statistical Analysis

In this section, I first consider the appropriate statistical model for the data spanning the 14 OECD countries across the 1976-1990 period. Then I examine results for the subset of countries with a proportional representation electoral system. Finally, I consider the robustness of the results with sensitivity analyses across time and space.

3.2.A The Main Model

Having considered how to operationalize the variables, I now turn to the functional form that I wish to specify econometrically. The model, without controls, is:

$$BMRATIO = f\,(LRPP^{+},\ AGDP^{+},\ LBP^{+},\ MOB^{-}) + \varepsilon \qquad (1)$$

BMRATIO is the bank-market orientation of the country, where an increasing value indicates a more banking-oriented financial system. LRPP is the interaction of left and rural political power; AGDP indicates the percentage of a country's GDP deriving from agriculture; LBP is the measure of labor's bargaining power via labor market institutions; and MOB is systemic capital mobility. The predicted direction of the effect of the variables is indicated with +/- signs.

Before considering the appropriate functional form of the test equation, we need to consider whether the dependent variable has a unit root. It is probably clear from looking at figure 3A.1 that a unit root exists, and indeed, tests reveal that this is the case. Performing an augmented Dickey Fuller test suggests that there is cointegration (we can reject integration at the 5% level).[4] We also need to consider how to deal with potentially cointegrating independent variables. To circumvent the potential problem of cointegration, Beck (1991) suggests using an error correction model, which does not necessarily require clear determination of the same order of integration in the "nearly cointegrating" factors. Nor does it require firm a priori decisions about which variables potentially cointegrate with the dependent variable and which do not. The error correction model also permits us to deal with the unit root of the dependent variable by taking its first difference. The structure of the error correction model is the following:

$$\Delta Y_t = \Delta X_t\beta + \gamma(Y_{t-1} - X_{t-1}\nu) + \varepsilon_t \qquad (2)$$

The term in parentheses is the error correction mechanism (ECM), which shows how far the independent variables are out of equilibrium with the bank-market orientation of the financial system; the coefficient on the ECM measures the speed at which the bank-market orientation returns to its equilibrium value with respect to the independent variables.

Two important advantages come from using this model. One, the coefficients are easily interpretable, where the first difference of a variable indicates its short-run change, while a change in the lagged level is its long-run effect. Second, it makes sense with respect to the relationship among the variables, where the bank-market orientation of a country adjusts if it is out of equilibrium with the independent variables, but the independent variables do not adjust to move into equilibrium with the bank-market orientation of the country.[5]

Thus, to determine the speed at which the dependent variable changes with respect to changes in the independent variables, I regress both the difference and lagged levels of the independent variables, thereby allowing the data to reveal how quickly or slowly the variables impact the bank-market orientation of the financial system. The regression equation, without controls, is:

$$\Delta BMRATIO_{i,t} = \Delta C\beta_{0i} + \Delta LRPP_{i,t}\beta_{1} + LRPP_{i,t-1}\beta_{2} + \Delta AGDP_{i,t}\beta_{3} + AGDP_{i,t-1}\beta_{4} + \Delta LBP_{i,t}\beta_{5} + LBP_{i,t-1}\beta_{6} + \Delta MOB_{i,t}\beta_{7} + MOB_{i,t-1}\beta_{8} + BM_{i,t-1}\beta_{9} + BM_{i,t-2}\beta_{10} + \varepsilon_{i,t} \qquad (3)$$

In estimating the model, I use ordinary least squares with panel corrected standard errors as recommended by Beck and Katz (1995). To remove autocorrelation of the errors, I use two lags of the dependent variable. Table 3.8 illustrates the results for the model, adding explanatory and control variables to check the robustness of the labor-rural political power term and to illustrate the effects of variables of interest as they are added.

Table 3.8: Regression Models for all Countries

Dependent Variable: Δln(Bank Assets/Stock Mkt. Cap.)

Explanatory Variables	**Expected Sign**	**(1)**	**(2)**	**(3)**	**(4)**
$\Delta LRPP_{i,t}$	+	.009**(2.3)	.006**(1.91)	.006*(1.9)	.007**(2.3)
$LRPP_{i,t-1}$	+	.003(1.5)	.004***(2.6)	.004**(1.9)	.004(1.4)
$\Delta LPP_{i,t}$		-.2**(-2)	-.14(-1.5)	-.14*(-1.6)	-.19**(-2)
$LPP_{i,t-1}$		-.04(-0.9)	-.08**(-2.3)	-.077(-1.3)	-.08(-1)
$\Delta RPP_{i,t}$		-.13(-1.2)	-.12(-1.1)	-.15(-1.2)	-.09(-.8)
$RPP_{i,t-1}$		-.005(-1.2)	-.007**(-2)	-.004(-0.7)	-.005(-.8)
$\Delta LBP_{i,t}$	+		.16*(1.7)	.15(1.6)	.17**(2)
$LBP_{i,t-1}$	+		-.006(-0.7)	.017(0.65)	.02(.85)
$\Delta AGDP_{i,t}$	+		.03(.43)	.05(0.6)	.06(.87)
$AGDP_{i,t-1}$	+		-.003(-.26)	-.002(-.1)	.01(.94)
$\Delta MOB_{i,t}$	-		-.23(-1.3)	-.22(-1.18)	-.1(-.6)
$MOB_{i,t-1}$	-		-.29*(-1.8)	-.28*(-1.6)	-.35**(-2.1)
Control Variables					
French				.094(.897)	.08(.7)
German				.07(.9)	.078(1)
Scandinavian				.011(.12)	-.04(-.5)
$\Delta Openness_{i,t}$					.29(1.5)
$Open_{i,t-1}$					-.03(-.76)
$\Delta GDPcap)_{i,t}$					2.13(1.5)
$(GDPcap)_{i,t-1}$					.18(1.3)
$\Delta Open^*$ $GDPcap_{i,t}$					-.03(-1.5)
$Open^*$ $GDPcap_{i,t-1}$					.003(.8)
BankC					-.06(-.57)
Constant		.117(1)	.66**(2.26)	.49(1.5)	-1.2(-.98)
$lnBM_{i,t-1}$		.28(1.6)	.18(1.1)	.19(1.23)	.2(1.4)
$lnBM_{i,t-2}$		-.35**(-2.15)	-.25*(-1.65)	-.3**(-1.9)	-.3**(-2)
rho (serial correlation of the error term)		-.003	.0003	-.004	.02
N		170	167	167	167
Adj. R^2		0.2	0.3	0.325	0.397

Note: z-statistics are in parentheses.
*** statistically significant at the 1% level.
** statistically significant at the 5% level.
* statistically significant at the 10% level.

First, notice that the combination of left and rural political power is significant in the correct direction. The change of this power from year to year indicates that there is a short-term effect on the structure of the financial system. Whether this is the result of markets responding quickly to changes in information (i.e., in this case, the likelihood of changes in regulation over the financial system and/or the changing level of enforcement of specific policies) or the immediate consequences of changes in the implementation of policies governing the financial system by the bureaucracy (e.g., the Treasury) will be evaluated in the case studies.

Interpreting the coefficients for changes in rural political power and the left's political power is not straightforward, however. To facilitate the interpretation, we can turn to graphical examples, which are useful in identifying the long-run relationship. In figure 3.6, I plot the response of the bank-market ratio to smooth increases in rural political power from the minimum to the maximum values across the data set (3.6 to 41.1) at four levels of left political power: the USA (0.72) which has the lowest average value; next is Germany (1.63); then Italy (2.78); and Austria (3.3) with the highest average value. The figure also lists other countries' averages for left political power so that the reader can place the approximate response of whatever country she likes.

The following figures remove the logarithmic transformation of the dependent variable to effectively represent the real-world change. Accordingly, figures 1.A1 to 1.A14 provide a useful reference for appreciating the impact of the independent variables on the dependent variable. I should also note that I do not include the 95% confidence intervals on the following figures because they would make the figures very cluttered and detract from the presentation of the key results.

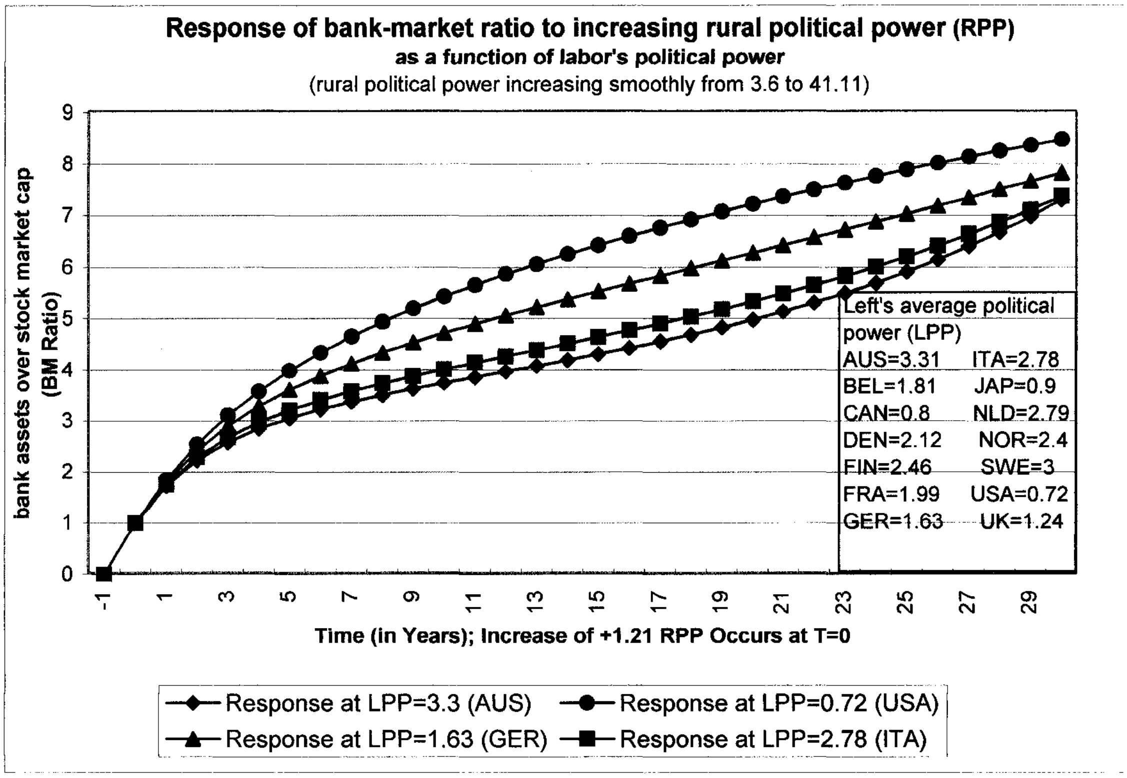


Figure 3.6: Response of Bank-Market Ratio to Rural Political Power

According to the theory, we expect that increasing values for rural and left political power are more likely to overcome veto-gates and lead to policy favoring banks. The figure illustrates that increasing values for rural political power lead to more banking-oriented systems in all countries in the sample. Interestingly, however, countries with low levels of left political power are more influenced by increasing rural political power, and therefore move toward higher levels of banking-dominance more quickly. This suggests that the left constrains, in a small way, the move toward banks.

The estimated effects of left's political power in figure 3.7 likewise support the hypotheses in some ways, but also contain some surprises. Allowing labor's political power to increase from its low of .05 to 4.028 (above the sample's high of 3.67), I fix rural political power at five different levels: Belgium's rural political power has the lowest average (4.38); followed by the UK (11.7); next is Germany (17.1); then France (28.3); with Finland having the highest average rural political power (39.9).

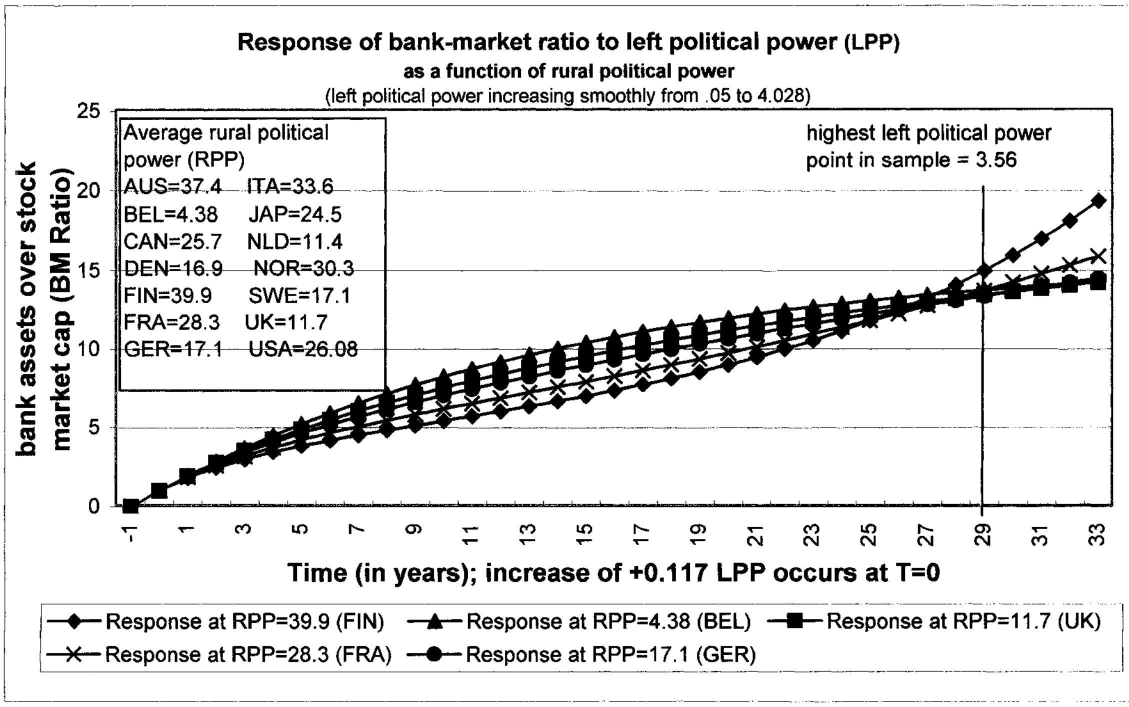


Figure 3.7: Response of Bank-Market Ratio to Left Political Power

The results suggest that with high rural and left political power, a country will quickly become more banking-oriented, resembling the results from figure 3.6. This corresponds to the theoretical expectations since these groups are more likely to overcome veto-gates when they both have high levels of political power. However, we would also expect high levels of left and rural political power to correspond with more banking-oriented countries. We do not see this occur until the left's political power exceeds the highest point in the sample. Breaking the analysis down into proportional representation countries may be helpful since these countries have higher levels of left and rural political power relative to nations with plurality electoral systems; I turn to this in the next section.

Looking at left and rural political power variables individually, we see that the left has a statistically significant impact independent of its interaction with rural political power. The negative coefficient is not a cause for concern since this reflects its influence relative to the interacting variable. This is reasonable considering the left's greater political influence across countries for the contemporary period. Additionally, we see that the rural political power variable is not significant. There are a couple reasons for labor's political power significance while rural political power is not. First, rural political power may be so small that it has little influence relative to the left's political power. A second reason is that the dependent variable primarily measures nonagricultural firms' financing needs. Thus, rural interests have a negligible impact on this variable. Looking at rural interests' impact on particular policies, and the proportion of the financial system influenced by agriculture in the case study chapters will permit us to determine whether they do prefer bank financing to market financing, and the extent of their influence.

Labor bargaining power also exert a short-term effect at a statistically significant level, pushing the country towards banks as labor's bargaining power increases (a 1 point short-term change in labor market institutions causes a 1.18 point change toward banks; to get 1.18 I multiply 0.17 times the exponential to remove the logarithmic transformation). The case studies will be useful for discerning how this short-term correlation plays out. The figure also illustrates a linear relationship, where countries with higher levels of labor bargaining power have commensurately more banking-oriented financial systems.

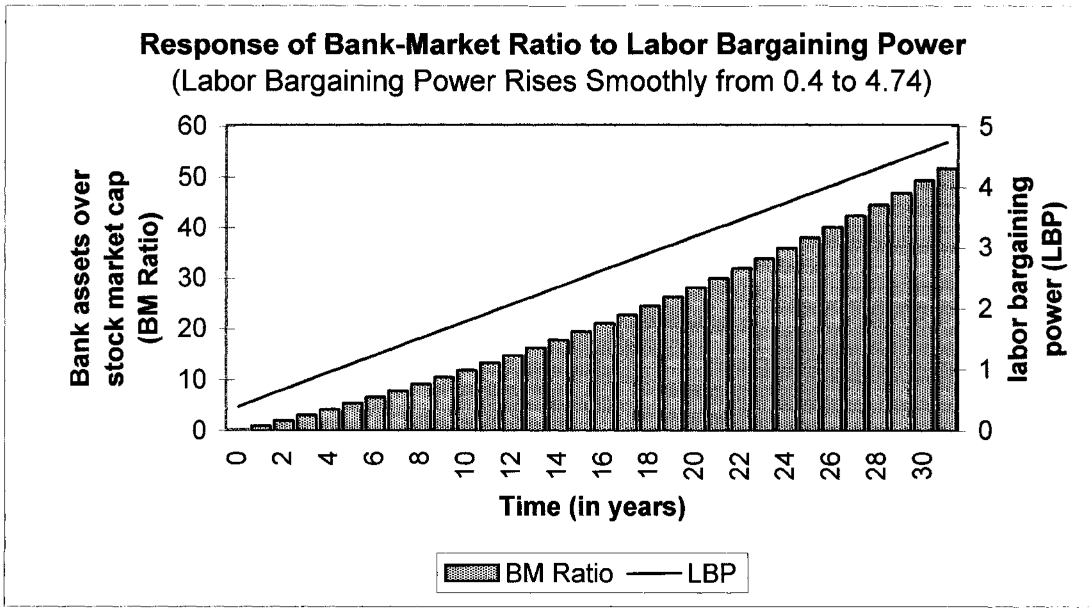


Figure 3.8: Response of Bank-Market Ratio to Labor Bargaining Power

The economic power of the rural sector, however, does not exert any statistically significant influence on the structure of the financial system. This result will be useful to bear in mind when examining the case studies.

As international capital mobility increases, countries move toward markets, as expected. The lagged effect indicates that there is a delayed effect on the structure of the financial system as a result of increasing international capital mobility. One scenario is that large firms seek cheaper financing elsewhere in period 1, and then domestic financial systems change to keep large firms' business at home in period 2. The causal mechanism will be evaluated in the case studies.

The coefficient on systemic capital mobility indicates that capital mobility's effect diminishes quickly. This suggests that low levels of systemic capital mobility are required to push countries toward markets. That is, large firms exert considerable influence on the structure of a country's financial system with relatively low levels of systemic capital mobility. Moreover, this points to the importance of left and rural political power once systemic capital mobility's influence has been absorbed.

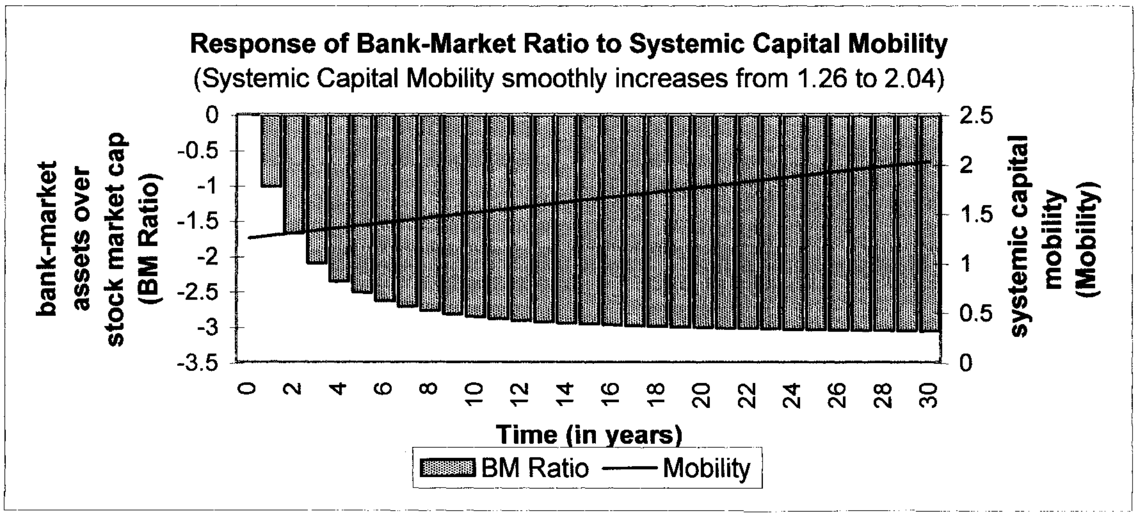


Figure 3.9: Response of Bank-Market Ratio to Systemic Capital Mobility

It is clear from figures 3.6 to 3.9 that systemic capital mobility has the potentially *smallest* impact on countries' financial systems. Extending the data set across the 1990s, however, would provide stronger evidence for capital mobility's limited influence since international capital mobility increased during this time. Labor bargaining power has the potentially largest impact.

It is noteworthy that none of the legal systems variables is significant, nor are the openness, GDP per capita, or the interactive variables significant, illustrating the strength and robustness of my theory relative to these alternative explanations.[6]

3.2.B Analysis of Proportional Representation Countries

Next, I look at a subset of all countries to determine whether the left and farmers have greater influence over the structure of the financial system in proportional representation countries than those with plurality electoral systems. A word of caution needs to be made first, however. Because the cross-sectional variation permits us to quell our fears of unit root problems, reducing this variation may permit this problem to resurface. Indeed, the small number of plurality countries, 5, and their narrower variation with respect to the bank-market ratio as we saw in figure 1.1, would lead to problematic results if we perform statistical tests on the plurality countries. The primary fear with respect to a unit root is that we will get spurious results (i.e., we will see strong relationships between the independent variables and the dependent variable simply because they both display the same trend over time).

A way to resolve this problem is to look at the statistical results for proportional representation countries where there is greater variation on the dependent variable, and more countries: 9. With this test, I expect that the independent variables will have larger coefficients than those found in the regression model with all of the countries, illustrating that labor and farmers exert greater influence on the structure of the financial system in proportional representation countries.

Table 3.9: Regression Model for countries with a Proportional Representation electoral system.[7] Dependent Variable: Δln(Bank Assets/Stock Mkt. Cap.)

Explanatory Variables	Expected Sign	coeff. (z-stat)
$\Delta LRPP_{i,t}$	+	.012***(2.4)
$LRPP_{i,t-1}$	+	.006(1)
$\Delta LPP_{i,t}$		-.3***(-2.5)
$LPP_{i,t-1}$		-.17(-1.2)
$\Delta RPP_{i,t}$		-.03(-.12)
$RPP_{i,t-1}$		-.0008(-.05)
$\Delta LBP_{i,t}$	+	.2(1)
$LBP_{i,t-1}$	+	-.05(-1.2)
$\Delta AGDP_{i,t}$	+	-.036(-.5)
$AGDP_{i,t-1}$	+	-.016(-.8)
$\Delta MOB_{i,t}$	-	-.05(-.3)
$MOB_{i,t-1}$	-	-.5***(-3.2)
Control Variables		
French		-.15(-.9)
German		.17*(1.7)
Scandinavian		
$\Delta Open_{i,t}$		.5***(2.4)
$Open_{i,t-1}$		-.2**(-2)
$\Delta GDPcap_{i,t}$		2(.8)
$GDPcap_{i,t-1}$		-2.6**(-2)
ΔOpen* $GDPcap_{i,t}$		-.06***(-2.5)
Open* $GDPcap_{i,t-1}$		.02**(2.1)
BankC		-.05(-.3)
Constant		25.7**(2)
$\ln BM_{i,t-1}$		-.3***(-3.3)
$\ln BM_{i,t-2}$		
rho (serial correlation of the error term)		.09
N		109
Adj. R^2		0.465

Note: z-statistics are in parentheses.
*** statistically significant at the 1% level.
** statistically significant at the 5% level.
* statistically significant at the 10% level.

Note that the statistically significant key independent variables have larger coefficients in the model for proportional representation countries than in the model with all countries. Specifically, the coefficient for $\Delta LRPP_{i,t}$ is almost two times greater in the PR model (.012) as in the general model (.007), while the coefficient for $MOB_{i,t-1}$ in the PR model (-.5) is 70% higher than in the general model (-.35). Also note that the left's political power (LPP) is larger in the PR model.[8] These results support the hypothesis that proportional representation countries benefit small groups' political power and permit them to influence the structure of the financial system more than in plurality countries. However, rural political power still retains its insignificance; the case studies will be important for determining whether they exert an impact on the structure of a country's financial system independent of their interaction with left political power.

Interestingly, the labor bargaining power (LBP) variable is no longer significant, suggesting that labor's bargaining power is especially important in plurality countries and may compensate for their reduced political power. Rural economic power remains insignificant, making case study analysis important for testing whether they exert the sort of economic influence I expect. Also note that many of the control variables have now become significant.

Figure 3.10 illustrates that PR countries' bank-market ratio moves much more evenly across all PR countries as rural political power increases, no matter what level of labor political power they begin with. This is in contrast to the figure for all countries where countries with low levels of left political power would plateau despite increasing rural political power. This suggests that varying levels of left political power do not cause considerable variation on a country's financial system relative to rural political power. In other words, rural political power seems to be driving changes in the structure of the financial system. Also note that Germany (a country with relatively low left political power) exhibits a much greater change in the figure for PR countries relative to the figure for all countries. In figure 3.10 Germany's bank-market ratio moves from 0 to 30, while in the general model, its bank-market ratio moves from 0 to 8.

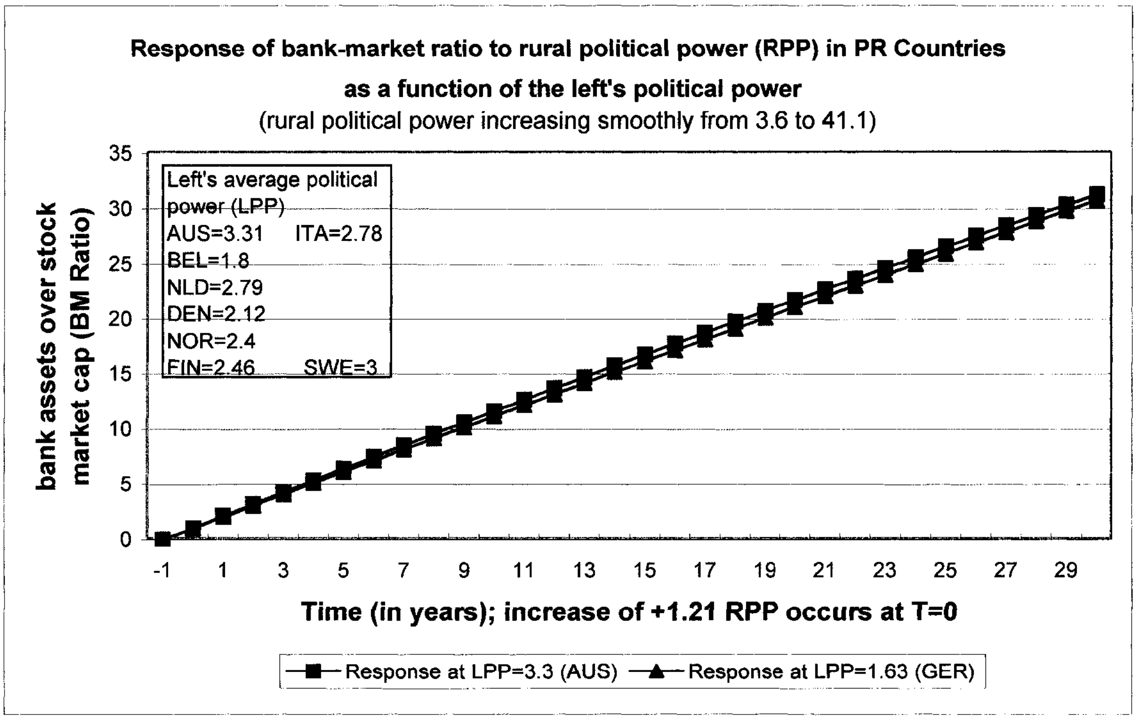


Figure 3.10: Response of Bank-Market Ratio to Rural Political Power in Countries with Proportional Representation Electoral Systems

Figure 3.11 is very similar to figure 3.10. It illustrates that increasing left political power moves a country toward banks, no matter what the level of rural political power. Thus, figures 3.10 and 3.11 offer support for left and rural political power playing a key role in impacting the structure of the financial system.

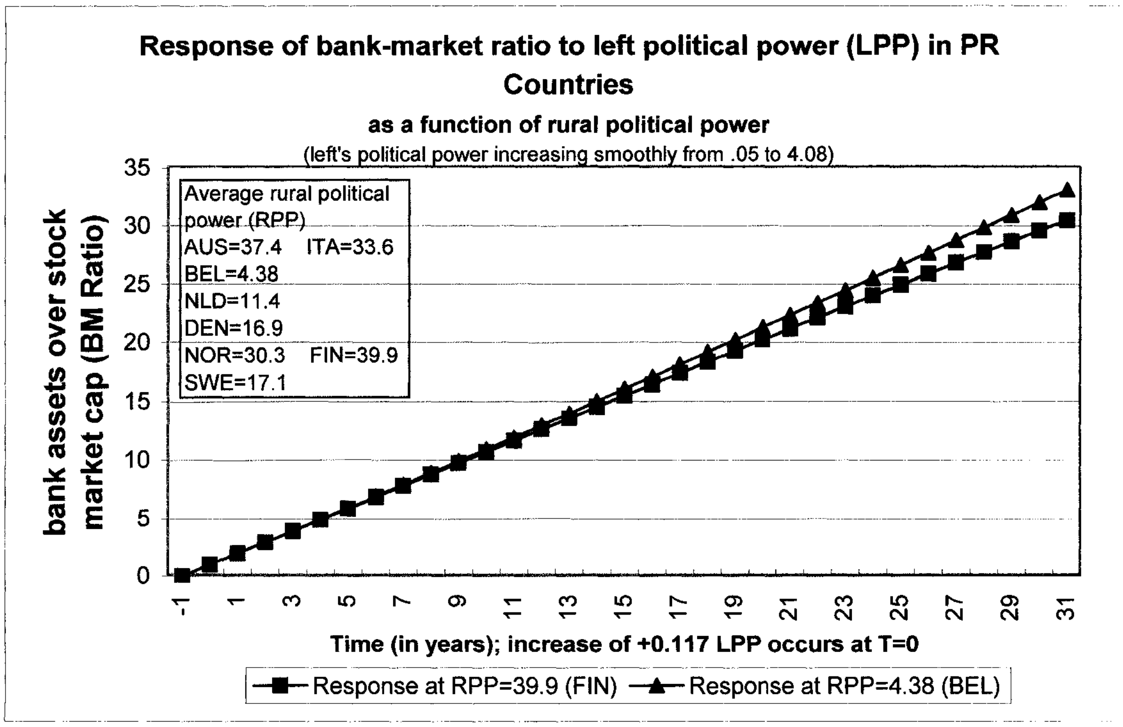


Figure 3.11: Response of Bank-Market Ratio to Left Political Power in Countries with Proportional Representation Electoral Systems

Figure 3.12 illustrates the influence of systemic capital mobility across PR countries. This is quite different from the figure for the general model, where systemic capital mobility's influence leveled off, with the bank-market ratio moving from 0 to –3. Here, however, capital mobility continues to influence countries' financial systems as it increases, pushing the bank-market ratio from 0 to –35. One likely reason is that PR countries are generally smaller than plurality countries, and therefore more easily influenced by international economic forces.

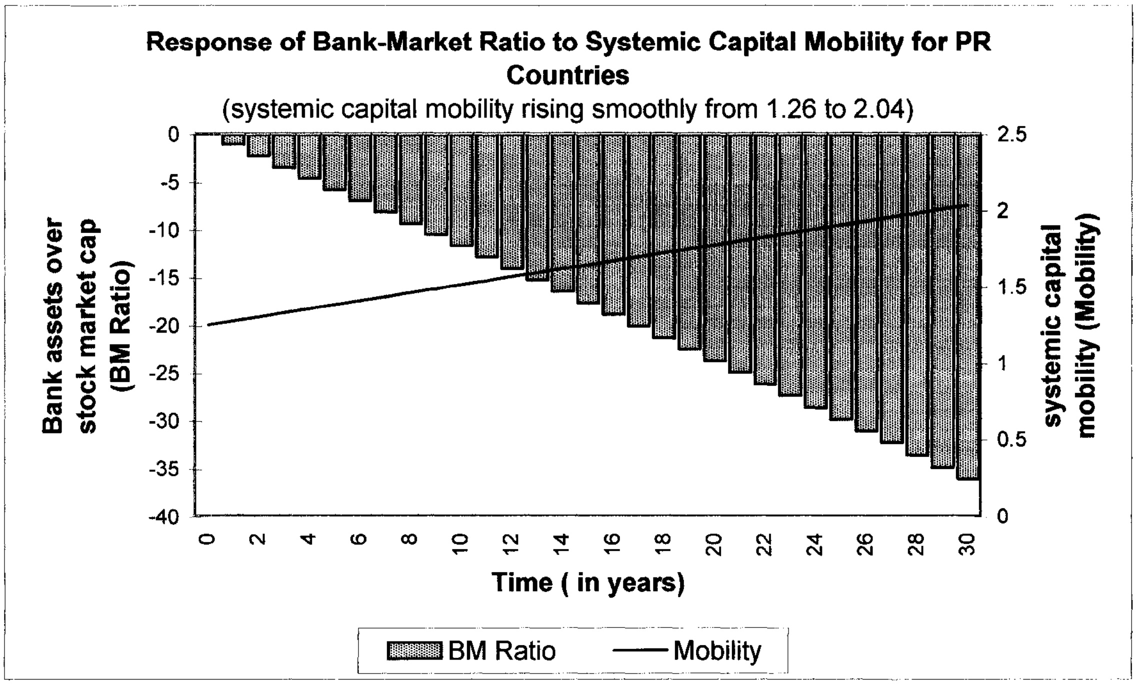


Figure 3.12: Response of Bank-Market Ratio to Systemic Capital Mobility in Countries with Proportional Representation Electoral Systems

The figures for the proportional representation countries illustrate that left and rural political power has about the same impact on a country's financial system as international capital mobility. The figures for the general model, however, illustrate that the interaction of left and rural political power has a potentially *greater* impact on the structure of a country's financial system than international capital mobility since LRPP can move the bank-market ratio from a minimum of 7.3 to a maximum of 15 points (at maximum values for left and rural political power) while systemic capital mobility moves countries' bank-market ratio a maximum of 3 points. Clearly, left and rural political power plays a bigger role in proportional representation countries, and it appears that labor's bargaining power may compensate for the lower left-rural political power in plurality countries.

3.3. Financial Systems in 1950, 1960, and 1970

We can also look at periods of relatively lower levels of international trade and capital flows to see whether left-rural political power remains strongly correlated with the bank-market orientation of the financial system. For 1970, I take the average level of left political power, the rural population, labor union power, and openness (imports + exports/GDP) from 1966-1970 from Garrett's dataset, and the ratio of bank deposits to stock market capitalization for 1970, as provided by Rajan and Zingales (2003). Because we are looking at one point in time, systemic capital mobility is held constant. The following figures graphically illustrate the correlations. Note that countries with proportional representation electoral systems more often display a linear correlation, as we would expect since this electoral system translates votes into seats in a more 'proportional' manner than plurality electoral systems. Countries with this latter system generally do not display a correlation since they privilege the median voter over the representation of smaller interest groups. Notice, in particular, that France has the weakest left-wing political power -- weaker than that found in the US, UK, Canada, and Japan at this time because the right-wing Gaullists are in power.

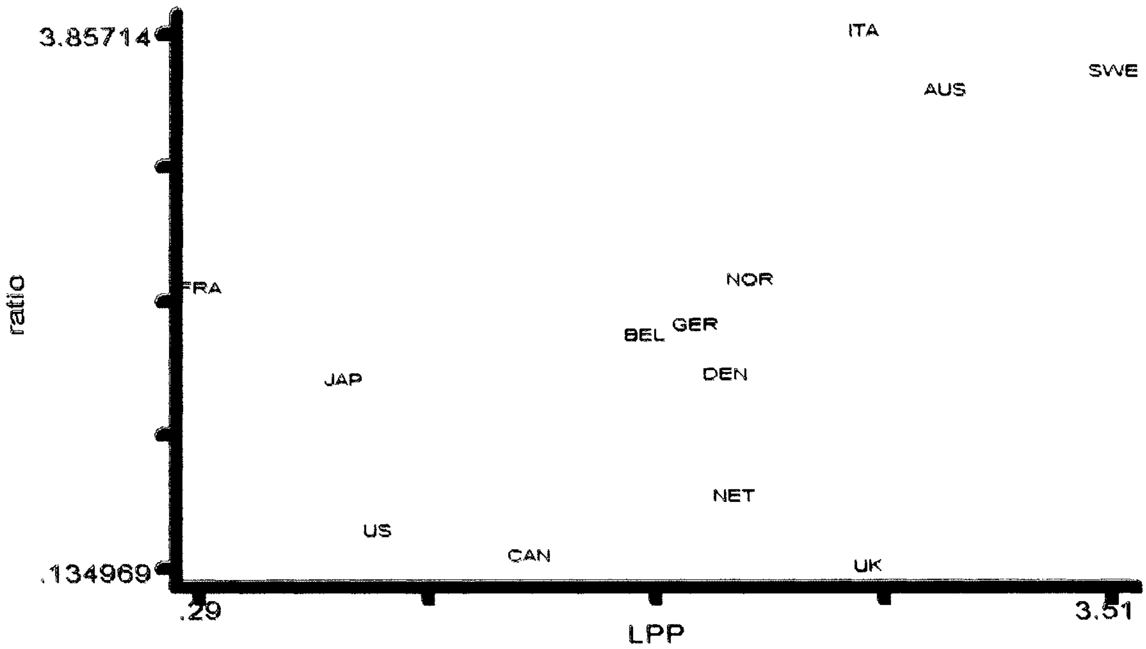


Figure 3.13: Bank Deposits/Stock Market Cap. and Left Political Power, 1970

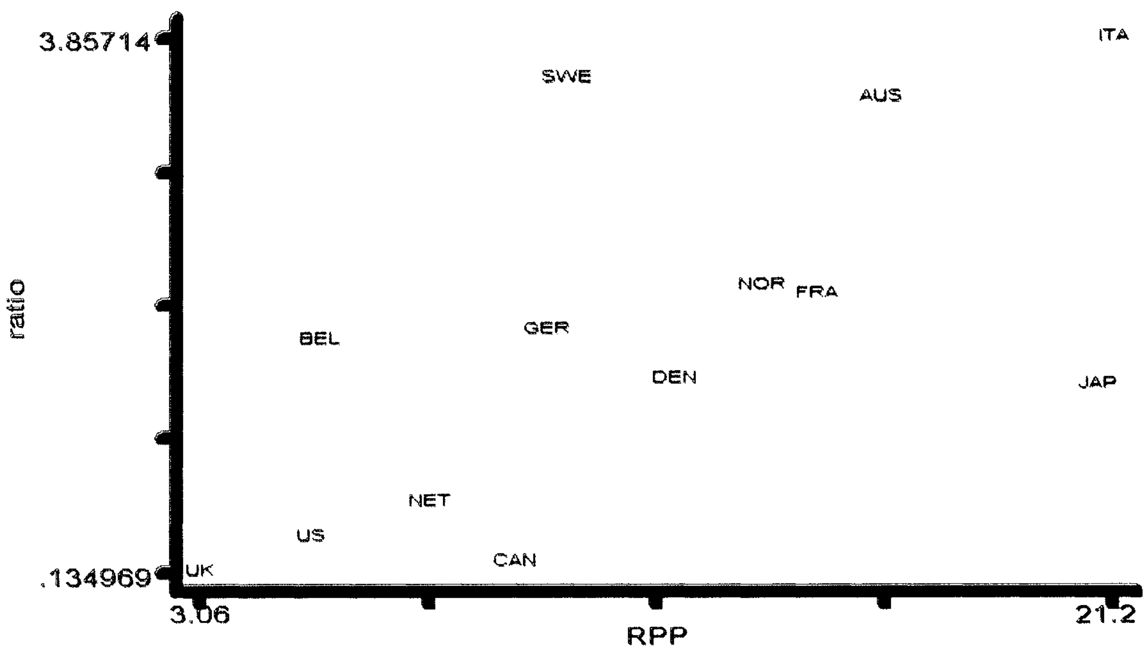


Figure 3.14: Bank Deposits/Stock Market Cap. and Rural Political Power, 1970

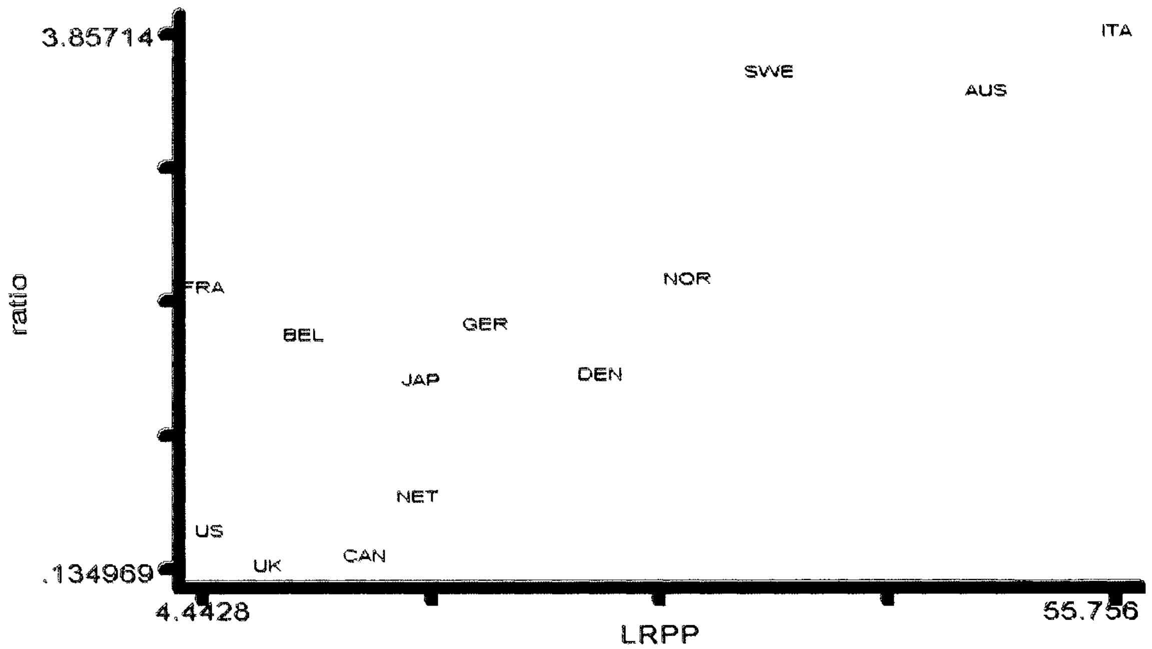


Figure 3.15: Bank Deposits/Stock Market Cap. and Left-Rural Political Power, 1970

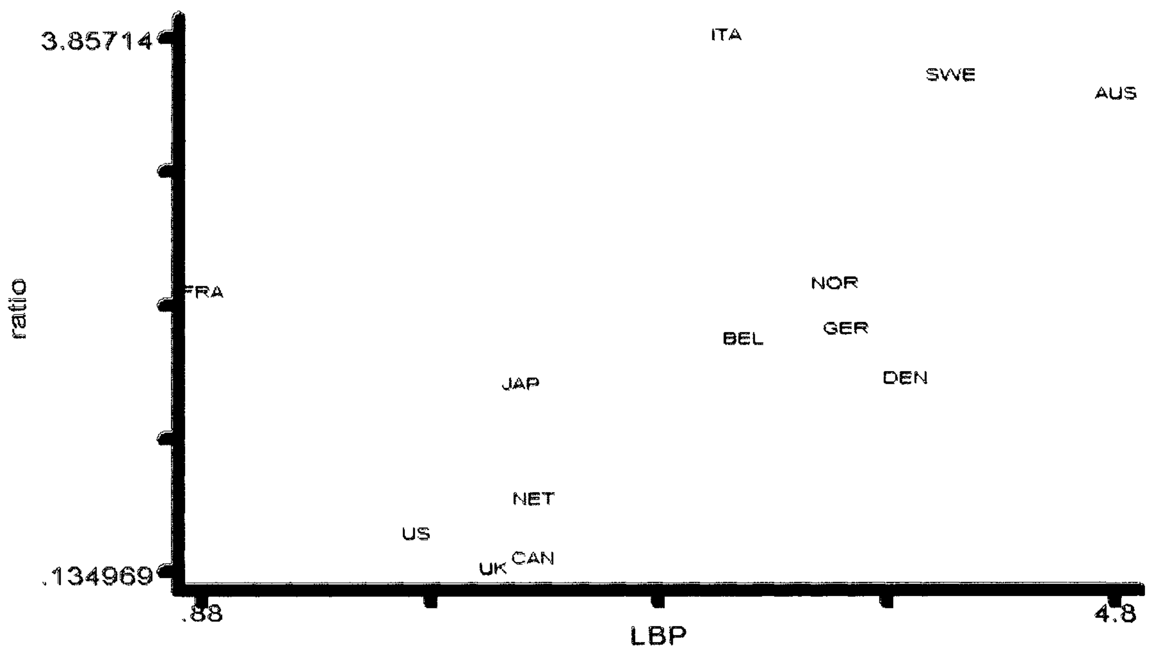


Figure 3.16: Bank Deposits/Stock Market Cap. and Labor Bargaining Power, 1970

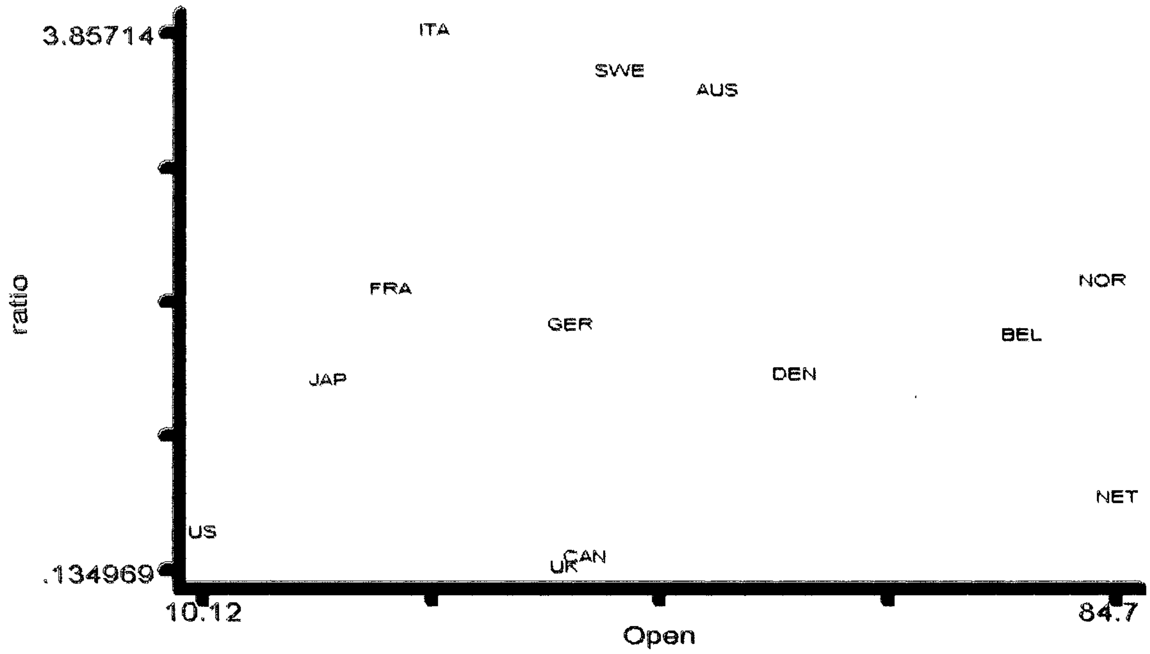


Figure 3.17: Bank Deposits/Stock Market Cap. and Openness, 1970

The following table numerically describes the correlations observed in figures 3.13-3.17, using a Bonferroni correction to account for the possibility of a spurious correlation.

Table 3.10: Correlation Matrix with Bonferroni Correction

	ratio	LPP	RPP	LRPP	LBP	Open
ratio	1					
LPP	.48	1				
RPP	.63	-0.08	1			
LRPP	.82*	.68	.61	1		
LBP	.59	.77*	.17	.73	1	
Open	.01	.41	-0.23	.13	.42	1

Note: * indicates variables that are significant at the 5% level with the Bonferroni correction. The Bonferroni correction is a method developed to deal with problems arising from multiple tests. In any significance test the probability of making a Type I error is equal to the significance level. Thus, at a significance level of 0.05 there is a 1 in 20 chance of making a Type I error. For example, suppose that you have 2 groups and 20 variables. You may wish to know if the two groups differ with respect to the means for these 20 variables. Therefore you carry out 20 t-tests. If *alpha* is 0.05 the expected number of Type I errors from 20 t-tests is 1, implying at least one spurious significant difference.

With respect to the dependent variable, the labor-rural political power variable is the only one with a correlation passing the 5% significance level with the Bonferroni correction. There is also a strong correlation between the labor-rural political power variable and the labor bargaining power variable. To determine which one is playing the stronger role with regard to financial system, I regress them together in model 6 in table 3.11. I also regress the other variables on the bank-market ratio variable, and it is clear that the labor-rural political power variable has the strongest correlation. Openness has the weakest correlation, corresponding the argument made in chapter two that low levels of international trade and capital flows do not necessarily privilege a banking-oriented financial system; rather, it is simply easier to sustain banking-dominated finance if domestic interests prefer it (e.g., usually to support and promote infant industries).

Table 3.11: Politics and the Financial System in 1970

DV: Ratio of Bank Deposits over Stock Market Capitalization

	M1	M2	M3	M4	M5	M6
LPP	0.67* (1.818)					
RPP		0.13** (2.73)				
LRPP			0.06*** (4.87)			0.06*** (3.2)
LBP				0.69** (2.45)		-0.04 (-.137)
Open					.0008 (.051)	
Constant	.44 (.555)	0.137 (0.2)	.319 (.88)	-0.259 (-0.29)	1.72* (2.073)	.396 (.589)
N	13	13	13	13	13	13
Adj. R-Squared	0.16	0.35	0.65	0.29	-0.09	0.62

Note: t-statistics are in parentheses
*** significant at the 1% level.
** significant at the 5% level.
* significant at the 10% level.

In the next two figures and tables for 1960 and 1950, I use different measures for left-wing and rural political power since Garrett's dataset only extends back to 1966. For left-wing political power, I use organized labor's (i.e., union membership) share of the popular vote from Crouch (1993, 197-8 and 224). This measure is problematic since it fails to account for the actual seats won in the legislature, and it fails to account for the share of cabinet positions held. In proportional representation countries, this measure is less problematic than for countries with less proportional electoral systems (e.g., UK and France). I use it as a rough indicator of true left wing political power. For rural political power I use the agricultural work-force as a percentage of the total work-force (Crouch, 1993: 201 and 226). It is difficult to know whether this under or overestimates the size of the rural population since the size of the rural nonworking population may or may not be equal to the size of the nonrural nonworking population; additionally, it does not account for malapportionment which can have a nontrivial effect. Data are available for 1963 and 1950 for both variables. Finally, the dependent variable is also an approximation since it measures bank deposits rather than bank assets. In any case, the figures and regressions for 1960 and 1950 should be taken with a dose of salt, and are provided to see whether the results still hold up during more closed periods of trade and capital flows, and to determine if further investigation is merited.

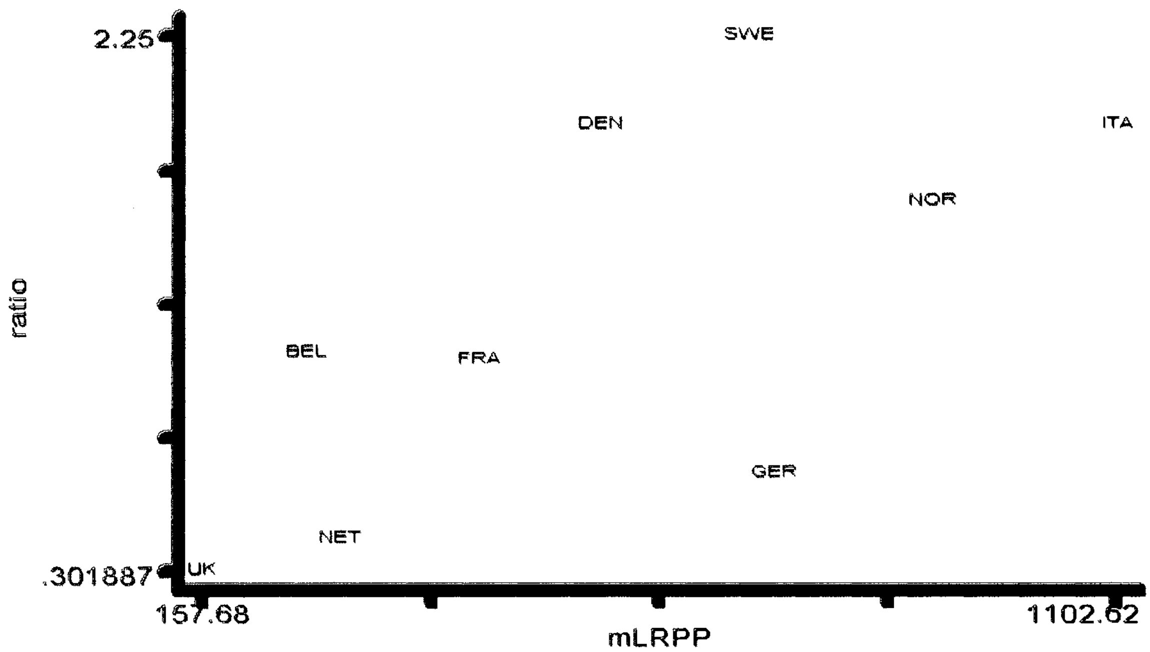


Figure 3.18: Bank Deposits/Stock Market Cap. and Modified Left-Rural Political Power, 1960

Table 3.12: Politics and the Financial System in 1960

DV: Ratio of Bank Deposits over Stock Market Capitalization

mLRPP	.0015** (2.4)
constant	.37 (0.9)
N	9
Adj. R-Squared	.38

Note: t-statistic in parentheses.
** significant at the 5 % level.

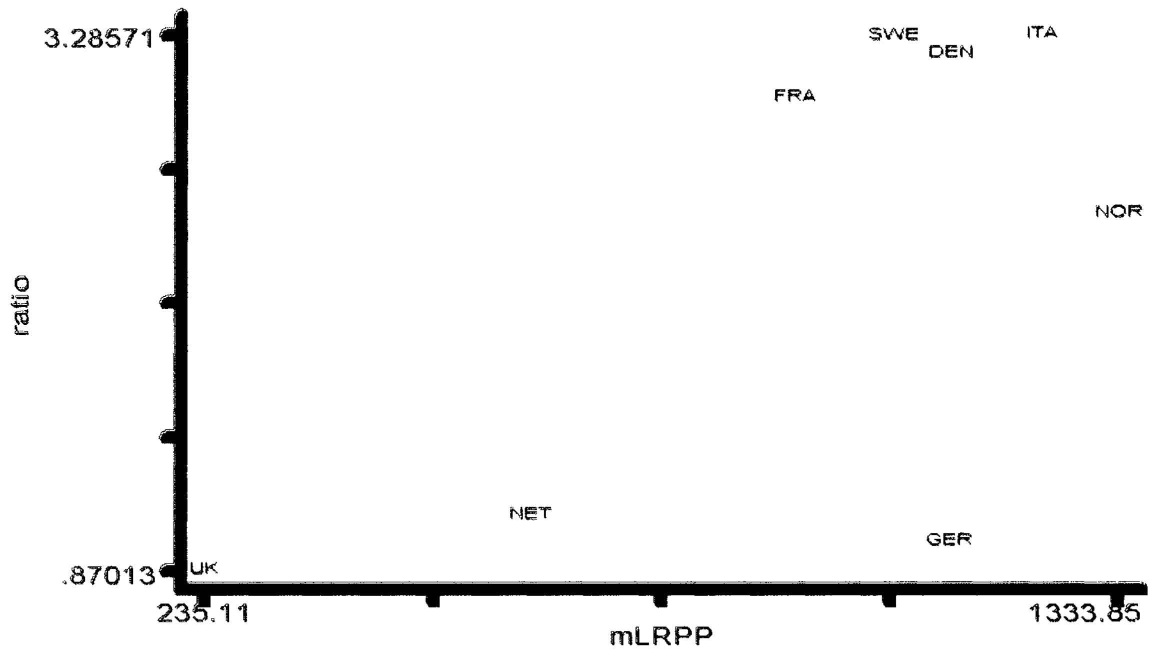


Figure 3.19: Bank Deposits/Stock Market Cap. and Modified Left-Rural Political Power, 1950

Table 3.13: Politics and the Financial System in 1950

DV: Ratio of Bank Deposits over Stock Market Capitalization

mLRPP	.0019* (2)	
constant	.41 (.42)	
N	8	
Adj. R-Squared	.31	

Note: t-statistic in parentheses.
* significant at the 10% level.

The results hold up surprisingly well given the measurement issues, even back to 1950 (although the relationship is fairly weak), a point in time when many European nations were still dealing with post-war problems such as capital scarcity, and directing funds to basic heavy industries in order to rebuild the economy. The results suggest that even during relatively more closed periods, the political power of labor and of rural interests retains a noticeable correlation with the bank-market orientation of national financial systems.

3.4. Conclusions

The regression analysis for the contemporary period (1976-90) suggests that the interaction of left-wing and rural political power has a potentially greater impact on the structure of a country's financial system than international capital flows. Additionally, the interaction of left-wing and rural political power has nearly twice as much influence in proportional representation countries relative to all countries. Left-wing political power appears to play a more influential role than rural political power across all fourteen countries, and is even more influential in countries with proportional representation electoral systems. International capital mobility also has about 70% more influence on proportional representation countries than the sample for all countries, which is likely due to these countries' smaller economies and greater sensitivity to the international economy. Finally, labor's bargaining power appears to be highly influential only in countries with plurality electoral systems. Rural economic power does not appear to be influential at all.

Thus, for the contemporary period, left-wing political power and international capital mobility are the most influential variables. Labor bargaining power is also important, but mostly for countries with plurality electoral systems. Because the rural population has declined considerably from its levels prior to World War II, while labor unionionism and left-wing parties have surged, it is not too surprising that rural political power plays a less influential role relative to labor. The case studies will be especially useful for determining whether rural political power has the expected impact on the financial system since they look across the twentieth century. Indeed, the Japan case study is particularly crucial in this regard since rural political power jumped after the war.

The statistical analyses for 1950, 1960, and 1970 point to the importance of left-wing and rural political power even when international capital mobility and trading levels are low. Indeed, the correlation appears to be even stronger in 1970 than during the period when international capital and trade flows are increasing. Nonetheless, the case studies will be essential for determining the merit of the causal argument that left-wing and rural interests push national financial systems toward a greater reliance on banking, since the regressions only illustrate the strength of the correlation between the independent and dependent variables.

Appendix 3A: Sensitivity Analysis

I check the robustness of the original regression by excluding countries and periods. All control variables were included in the regressions, but they are not shown in the table.

It should be highlighted that all the statistically significant variables in the original model retain their significance when we exclude each country one at a time, except for the first-difference of LRPP in the case of Britain, and the first-difference of LBP in the case of France. In this case LRPP is significant at the 15% level. The lag of the interaction between labor and rural political power becomes significant when we exclude Belgium, Canada, France, Norway, and the USA. The lag of AGDP becomes significant when we exclude Japan.

Table 3A.1: Robustness of OLS Estimates to the Exclusion of Countries
Dependent Variable: Δln(Bank Assets/Stock Mkt. Cap.)

	$\Delta LRPP_{i,t}$	$LRPP_{i,t-1}$	$\Delta LBP_{i,t}$	$LBP_{i,t-1}$	$\Delta AGDP_{i,t}$	$AGDP_{i,t-1}$	$\Delta MOB_{i,t}$	$MOB_{i,t-1}$
Coeff. ***p≤.01; **p≤.05; *p≤.1 (z-stat)								
AUS	.008*** (2.7)	.002 (.8)	.19*** (2.35)	.019 (.9)	.04 (.6)	.005 (.4)	-.06 (-.4)	-.27** (-1.9)
BEL	.006* (1.7)	.004* (1.65)	.15* (1.9)	.03 (.9)	.07 (.97)	.0006 (.039)	-.08 (-.5)	-.33** (-2)
BRI	.006 (1.4)	-.0007 (-.2)	.17* (1.8)	.02 (.7)	.05 (.7)	.014 (.89)	-.09 (-.5)	-.37** (-2.2)
CAN	.008*** (2.6)	.004* (1.7)	.16** (1.8)	.016 (.6)	.05 (.6)	.008 (.6)	-.11 (-.6)	-.4** (-2.3)
DEN	.008*** (2.4)	.0045* (1.6)	.15* (1.8)	.02 (.87)	.09 (1.2)	-.004 (-.2)	-.1 (-.6)	-.37** (-2.2)
FIN	.007*** (2.4)	.005** (2)	.18** (2.2)	.01 (.5)	.04 (.6)	.006 (.5)	-.14 (-.9)	-.38*** (-2.6)
FRA	.008** (1.9)	.005* (1.7)	.18 (1.5)	.04 (1)	.05 (.7)	.007 (.57)	-.09 (-.5)	-.34** (-2.1)
GER	.006* (1.6)	.004 (1.4)	.16** (2)	.016 (.6)	.07 (1)	.01 (1.1)	-.1 (-.6)	-.3** (-2)
ITA	.008*** (2.6)	.004 (1.5)	.22*** (2.5)	.06 (1.4)	.05 (.6)	-.004 (-.34)	-.12 (-.7)	-.33** (-2.1)
JAP	.0056* (1.65)	.003 (1)	.17* (1.7)	-.01 (.4)	.07 (.9)	.018* (1.7)	-.09 (-.5)	-.34** (-2)
NL	.009*** (2.5)	.004 (1.4)	.19** (2.3)	.027 (.8)	.09 (1.2)	.003 (.13)	-.07 (-.4)	-.33** (-2)
NOR	.007** (2)	.005** (1.9)	.17** (2)	.015 (.57)	.05 (.7)	.008 (.5)	-.1 (-.6)	-.37** (-2.2)
SWE	.006* (1.6)	.003 (.9)	.16** (2)	.03 (.9)	.07 (.9)	.004 (.3)	-.13 (-.7)	-.36** (-2)
USA	.008*** (2.5)	.005* (1.7)	.17* (1.9)	.016 (.6)	.057 (.75)	.009 (.76)	-.11 (-.6)	-.37** (-2.1)
full model	.007** (2.3)	.004 (1.4)	.17** (2)	.02 (.8)	.06 (.87)	.01 (.9)	-.1 (-.6)	-.35** (-2.1)

Now I turn to sensitivity analysis with respect to the exclusion of each year. The results for the first difference of LRPP remain robust to the exclusion of each year, except for 1981. The lag of LRPP becomes significant when we exclude 1976, 1977, 1979, 1980, 1982, 1983, 1988, and 1989. International capital mobility remains significant to the exclusion of every year except for 1985. LBP is also significant to the exclusion of each year except 1983 and 1986.

Table 3A.2: Robustness of OLS Estimates to the Exclusion of Years
Dependent Variable: Δln(Bank Assets/Stock Mkt. Cap.)

	$\Delta LRPP_{i,t}$	$LRPP_{i,t-1}$	$\Delta LBP_{i,t}$	$LBP_{i,t-1}$	$\Delta AGDP_{i,t}$	$AGDP_{i,t-1}$	$\Delta MOB_{i,t}$	$MOB_{i,t-1}$
	Coeff. ***p≤.01; **p≤.05; *p≤.1 (z-stat)							
1976	.008*** (2.4)	.0045* (1.6)	.17** (2)	.02 (.7)	.06 (.8)	.006 (.5)	-.1 (-.6)	-.36** (-2.1)
1977	.008*** (2.4)	.005* (1.6)	.17* (2)	.02 (.7)	.06 (.8)	.006 (.5)	-.11 (-.6)	-.36** (-2.1)
1978	.008*** (2.4)	.005 (1.6)	.16* (1.8)	.01 (.5)	.03 (.47)	.002 (.15)	-.1 (-.6)	-.34** (-2)
1979	.01*** (2.6)	.005* (1.75)	.17** (2)	.02 (.9)	.1 (1.4)	.007 (.6)	-.05 (-.3)	-.33** (-2)
1980	.008*** (2.6)	.005** (1.9)	.17** (2)	.017 (.6)	.06 (.8)	.008 (.69)	-.09 (-.5)	-.35** (-2.2)
1981	.006 (1.5)	.004 (1.3)	.19** (2.2)	.03 (1.1)	.08 (.9)	.005 (.4)	-.12 (-.7)	-.38*** (-2.2)
1982	.008*** (2.7)	.003* (1.2)	.17** (1.9)	.03 (.9)	.05 (.7)	.007 (.57)	-.1 (-.6)	-.33** (-2)
1983	.008*** (2.7)	.005* (1.8)	.1 (1)	.004 (.16)	.03 (.3)	.008 (.6)	-.08 (-.4)	-.38** (-2.2)
1984	.008*** (2.4)	.005 (1.5)	.16* (1.9)	.02 (.8)	.02 (.3)	.005 (.37)	-.18 (-.9)	-.4** (-2.3)
1985	.006* (1.6)	.004 (1.4)	.2* (1.7)	.02 (1)	.06 (.8)	-.004 (-.4)	-.1 (-.5)	-.34 (-1.5)
1986	.007** (2)	.004 (1.4)	.13 (1.4)	.01 (.4)	.07 (.97)	.007 (.01)	-.45 (-1.3)	-.2** (-.87)
1987	.007** (2)	.004 (1.3)	.17** (2.1)	.013 (.5)	.05 (.6)	.01 (.8)	-.1 (-.6)	-.35** (-2)
1988	.008*** (2.6)	.005* (1.6)	.17** (1.9)	.02 (.7)	.07 (.9)	.009 (.8)	-.1 (-.6)	-.36** (-2)
1989°	.009*** (3.4)	.008*** (3.7)	.18*** (2.8)	.03 (1.2)	.14** (2.3)	.02 (1.3)	-.1 (-1.2)	-.37*** (-4)
1990	.007*** (2.5)	.001 (.6)	.18** (2.3)	.005 (.2)	.09 (1.4)	.003 (.2)	-.1 (-.8)	-.3*** (-2.5)
full model	.007** (2.3)	.004 (1.4)	.17** (2)	.02 (.8)	.06 (.87)	.01 (.9)	-.1 (-.6)	-.35** (-2.1)

° This particular regression suffers from excessively high serial correlation in the error term; rho = 0.2.

The sensitivity tests indicate that the first-difference of LRPP, the first difference of LBP, and the lag of MOB are quite robust variables.

Appendix 3B: Alternative Measures of the Dependent Variable

The following figure depicts a widely used measure for developed countries, namely deposit bank assets relative to stock market capitalization. This is considered a measure of the 'size' of the country's banking system relative to its stock market, and is the one used in the body of this chapter.

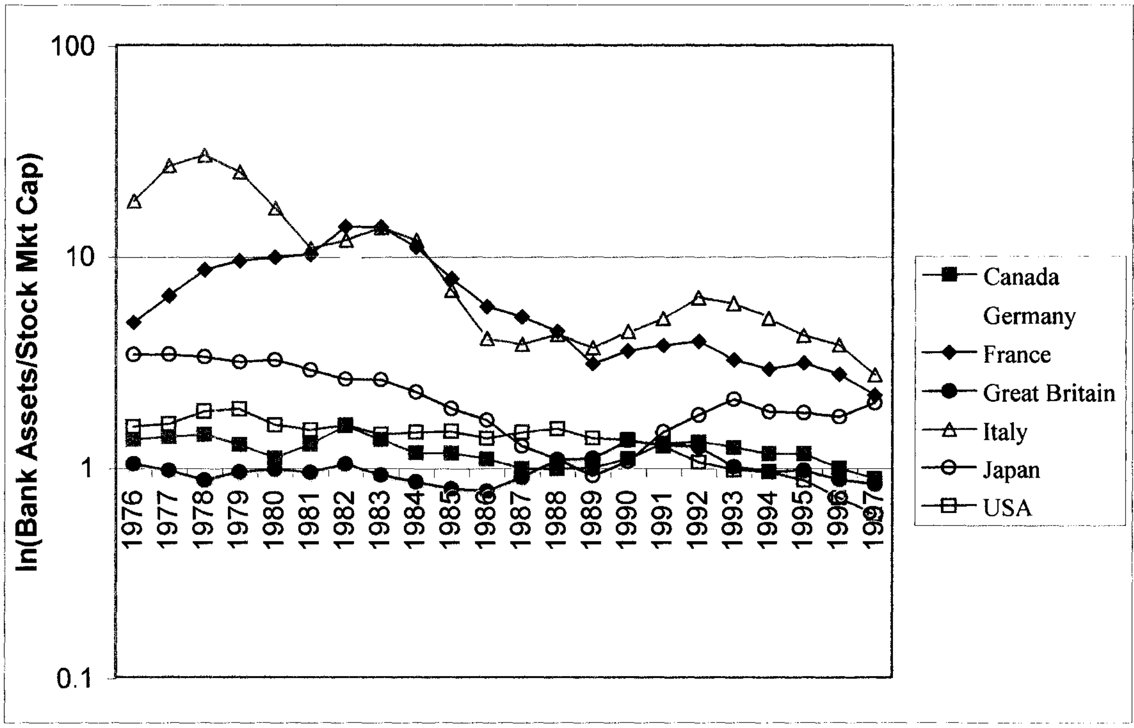


Figure 3B.1: Bank Assets - Market Capitalization Ratio, 1976-1997

We can turn to another measure of corporations that might seem to be satisfactory – asset allocation – however, the process of corporate decision-making is likely to influence asset allocation in a manner similar to that of financing. Thus, Hoshi and Kashyap's data on Japanese firms from 1900-1970 provides highly useful insight into the long-term trend of the financial system, but is an incomplete measure of the overall structure of a country's financial system.

I turn now to the measures compiled by Beck, Levine, and Demirguc-Kunt (1999). They construct a dataset based on measures of efficiency, activity, and size, which I will discuss in turn.

The efficiency measure uses the value of stock market transactions relative to the size of the economy with respect to two different measures of banks: (1) overhead cost; and (2) bank net interest margin. Because there are data only for the 1990s for the bank measures, this variable has limited usefulness from a time series perspective.

The activity measure is the ratio of private credit by deposit money banks relative to the total value of stock transactions on domestic exchanges. Here is its graphical representation across countries and time:

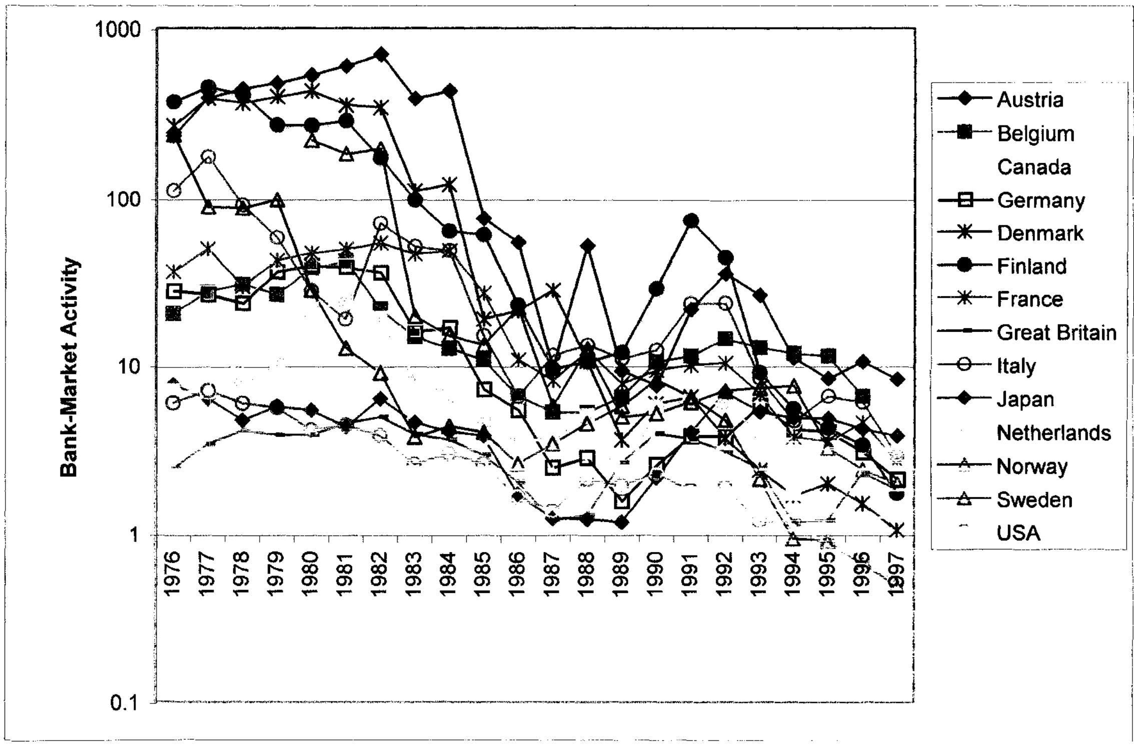


Figure 3B.2: Bank-Market Activity Measure, 1976-1997

There is a clear and dramatic trend toward markets over time across all countries. To determine why this is occurring, we can look at the two series comprising the ratio.

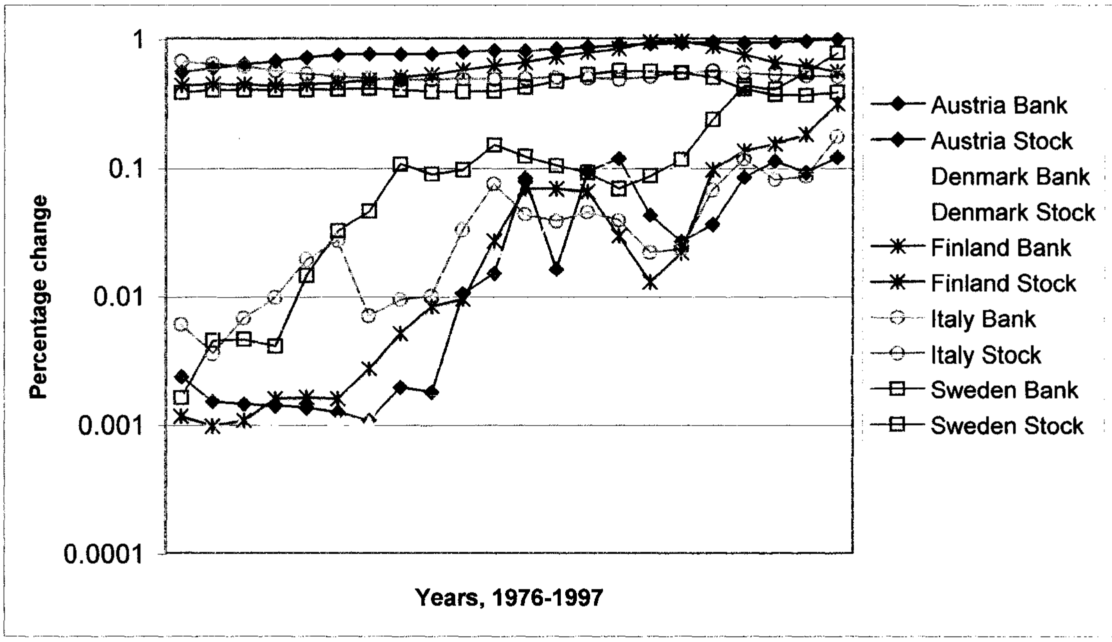


Figure 3B.3: Bank Credit and Stock Trading, 1976-1997

When we do so, it is clear that bank credit remains fairly constant, or even increases slightly, however, trading activity grows enormously over time. Let's compare these data to those comprising the size measure, which equals the domestic assets of domestic money banks relative to domestic stock market capitalization.

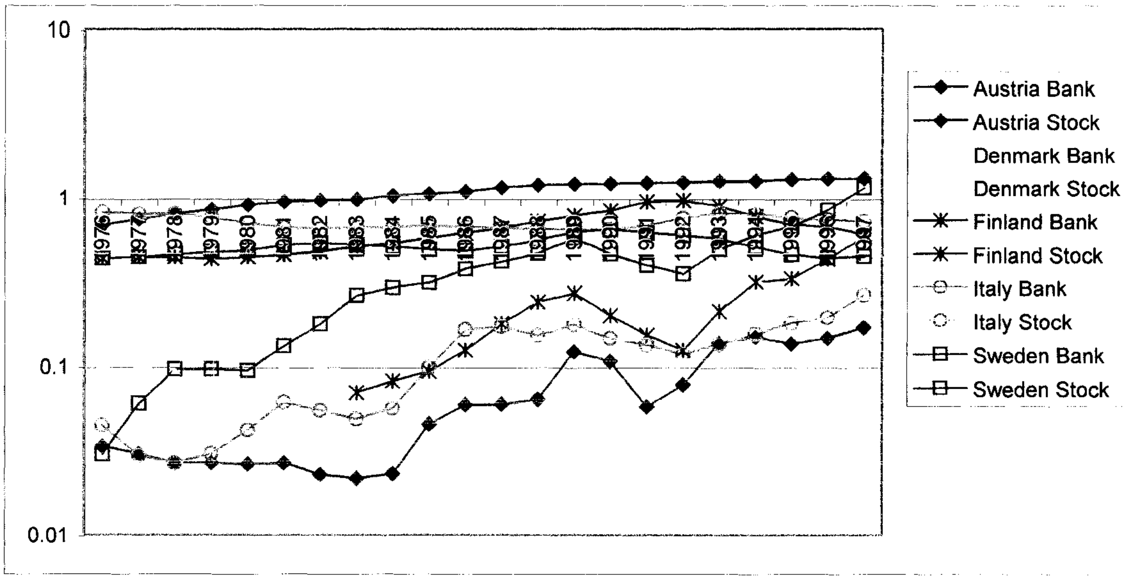


Figure 3B.4: Bank Assets and Stock Market Capitalization, 1976-1997

The activity and size measures clearly resemble one another, forcing us to question which provides a more useful measure of the financial system. To this end, let's consider what each variable actually measures:

Bank assets/GDP: this is the amount of money in the banking sector, measured, in this case, as relative to GDP.

Bank credit/GDP: this measures the total money lent to firms as a proportion of GDP.

Market capitalization/GDP: this is an indicator of the amount of money that firms are worth. Thus, more firms who are listed on the exchange, the higher this becomes (assuming that firms grow at the same rate as the GDP), with many small firms needed to make a noticeable difference. In order for firms to sell shares on an exchange, there needs to be sufficient liquidity—

an important point for the listing of small firms.

Trading amount/GDP: this measures the amount of money exchanging hands on the country's stock market. It is an indication of the market's liquidity.

Bank assets and bank credit are related to one another in the sense that banks' primary business is lending. Thus, the greater their assets (or their size), the larger their lending operations. This may change over time as banks' primary functions shift from lending to capital markets' supporting functions, such as underwriting and loan origination which then get securitized. For the time period under consideration (1976-1990)[9], it is reasonable to consider banks engaging primarily in lending.

The two stock market measures are also closely related. In fact, they exhibit a feedback effect on one another, where increasing liquidity leads to more firms being able to list. The greater the size of the market, the more trading that will occur. Of course, technological innovations and increased broker commission rate competition also stimulate increased trading. But the point is that we should not be terribly surprised that these series mirror each other.

Thus, is there any reason why we should choose one over the other? I select the size because it is a widely accepted measure for developed countries, as Beck, Levine, and Demirguc-Kunt (1999) note. It also makes more sense with regard to our understanding of these financial systems, as figure 3A.5 illustrates.

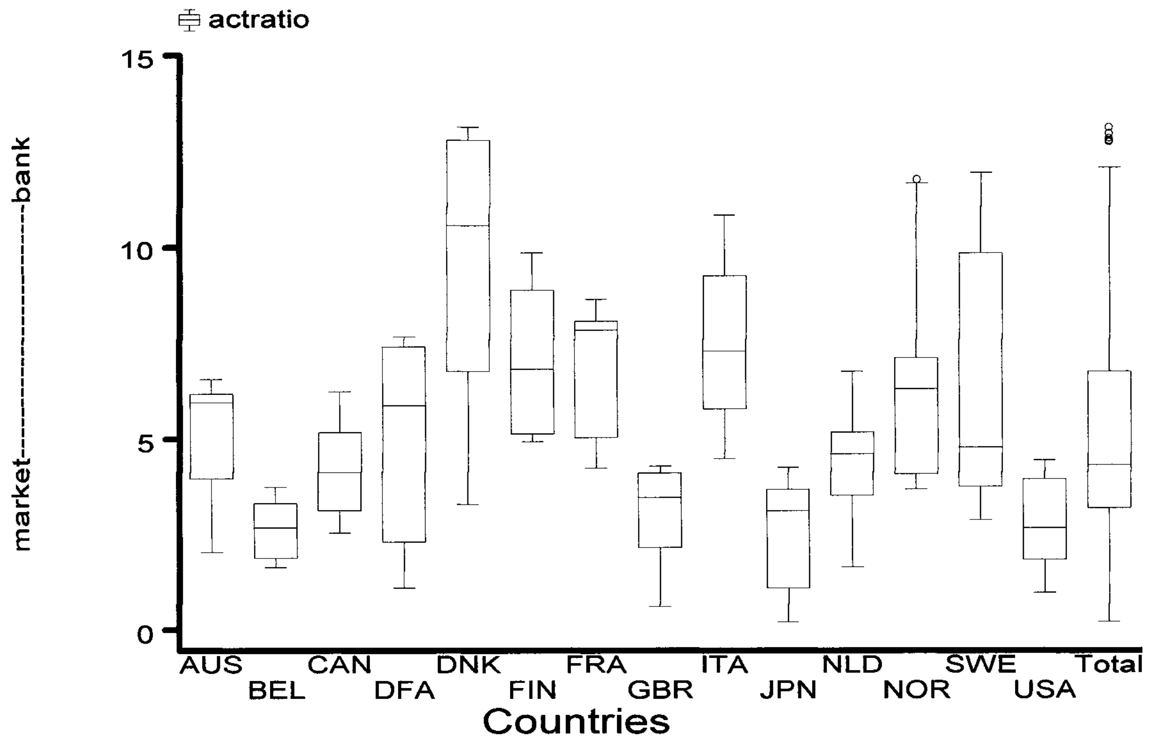


Figure 3B.5: Box Plot of the Activity Measure: ln(bank credit/trading amount)

Note that Japan is more market-oriented than Canada according to this measure. Indeed, according to this measure, Japan becomes more market-oriented than any other country during this period—more than Great Britain and the United States. Clearly, the measure is suspect. For the sake of completeness, I regress the variables from the main model for all countries on the activity measure.

Table 3B.1: Regression Model for Activity Measure.[10]
Dependent Variable: Δln(Bank Credit/Stock Mkt. Trading Amount)

Explanatory Variables	Expected Sign	coeff. (z-stat)
$\Delta LRPP_{i,t}$	+	.024(1)
$LRPP_{i,t-1}$	+	-.02(-1.2)
$\Delta LPP_{i,t}$		-.15(-0.2)
$LPP_{i,t-1}$		.96**(2.3)
$\Delta RPP_{i,t}$		-1.7*(-1.6)
$RPP_{i,t-1}$		.035(0.9)
$\Delta LBP_{i,t}$	+	.44(1.1)
$LBP_{i,t-1}$	+	.08(0.5)
$\Delta AGDP_{i,t}$	+	.59*(1.69)
$AGDP_{i,t-1}$	+	.22**(1.9)
$\Delta MOB_{i,t}$	-	.06(.09)
$MOB_{i,t-1}$	-	-.71(-1.1)
Control Variables		
French		-.6*(-1.7)
German		-.65**(-1.9)
Scandinavian		-.92***(-2.6)
$\Delta Open_{i,t}$		1.4(1.5)
$Open_{i,t-1}$		-1.4(-1.2)
$\Delta GDPcap_{i,t}$		.27(.04)
$GDPcap_{i,t-1}$		-1.4(-1.2)
$\Delta Open^*$ $GDPcap_{i,t}$		-.14(-1.5)
$Open^*$ $GDPcap_{i,t-1}$		.03(1.5)
BankC		-1.3**(-1.9)
Constant		13.5(1.2)
$lnBM_{i,t-1}$		-.46***(-3.3)
$lnBM_{i,t-2}$		.23*(1.76)
rho (serial correlation of the error term)		.04
N		167
Adj. R^2		0.36

Note: z-statistics are in parentheses.
*** statistically significant at the 1% level.
** statistically significant at the 5% level.
* statistically significant at the 10% level.

Appendix 3C: Additional Regressions

I also run regressions for the bank assets/GDP and stock market capitalization/GDP variables, without creating a single ratio variable. Below are the results. As mentioned in the body of the chapter, breaking the dependent variable down into these two separate components is theoretically unappealing since we cannot tell whether more money went to banks or markets even though both may increase.

Table 3C.1: Regression Model for two dependent variables: (1) bank assets/GDP; (2) stock market capitalization/GDP.

Dependent Variable:		**(1) Δbank assets/GDP**		**(2) Δstock mkt cap/GDP**
Explanatory Variables	**Expected Sign**	**coeff. (z-stat)**	**Expected Sign**	**coeff. (z-stat)**
$\Delta LRPP_{i,t}$	+	.0009(.813)	-	-.0005(.5)
$LRPP_{i,t-1}$	+	.002***(2.6)	-	.0009(1)
$\Delta LPP_{i,t}$		-.02(-.687)		.015(.5)
$LPP_{i,t-1}$		-.06***(-2.75)		-.03(-1.4)
$\Delta RPP_{i,t}$		.01(.38)		.05(1.3)
$RPP_{i,t-1}$		-.005***(-2.4)		-.003(-1.4)
$\Delta LBP_{i,t}$	+	.02(1.3)	-	-.06*(-1.6)
$LBP_{i,t-1}$	+	-.008(-1.5)	-	-.016**(-2.1)
$\Delta AGDP_{i,t}$	+	.02***(2.5)	-	.014(.75)
$AGDP_{i,t-1}$	+	.002(.846)	-	-.0003(-.12)
$\Delta MOB_{i,t}$	-	.0004(.03)	+	-.002(-.03)
$MOB_{i,t-1}$	-	-.007(-.49)	+	.06(1.2)
Control Variables				
French		.045***(2.5)		.01(.5)
German		.07***(2.6)		.04*(1.7)
Scandinavian		.03**(1.7)		.05**(2.3)
$\Delta Open_{i,t}$		-.03(-1.5)		-.09(-1.5)
$Open_{i,t-1}$		-.004(-.72)		.009(.9)
$\Delta GDPcap_{i,t}$		-.16(-.83)		-.35(-.7)
$GDPcap_{i,t-1}$		.03(.7)		-.02(-.2)
$\Delta Open^{*} GDPcap_{i,t}$		.004(1.5)		.01(1.6)
$Open^{*} GDPcap_{i,t-1}$		.0004(.62)		-.001(-1)
BankC		.05*(1.6)		.04*(1.6)
Constant		-.07(-.169)		.24(.28)
$Bank_{i,t-1}$		.5***(4.2)		
$Bank_{i,t-2}$		-.6***(-5.7)		
rho (serial correlation of the error term)		-.07		-.05
N		167		178
Adj. R^2		0.49		0.25

Note: z-statistics are in parentheses.
*** statistically significant at the 1% level.
** statistically significant at the 5% level
* statistically significant at the 10% level.

Appendix 3D: Unit Root Tests for the Main Model

The rho indicates that it is not necessary to worry about autocorrelation of the errors since it is very close to zero. But there is also the question of whether the dependent variable has a unit root. The z-stat on the lags of the dependent variable do not permit the rejection of the null of a unit root according to a dickey-fuller test. However, this should not be too great a cause for concern since most of the variation occurs on the cross-sectional dimension (as figure 1.1 illustrates), which unit root tests (i.e., the dickey-fuller test) do not account for.[11] The results indicate that about 85% of a shock in one year lasts into the next, then 85% of that lasts into the following year and so forth. This implies that it takes about 19 years for 90% of a shock's impact to be spent.

Because I incorporate two lags of the dependent variable into a time-series model, one of which has a positive coefficient and the other negative, we can check that a shock in the first period diminishes over time by plotting the rate of change of the dependent variable over time.

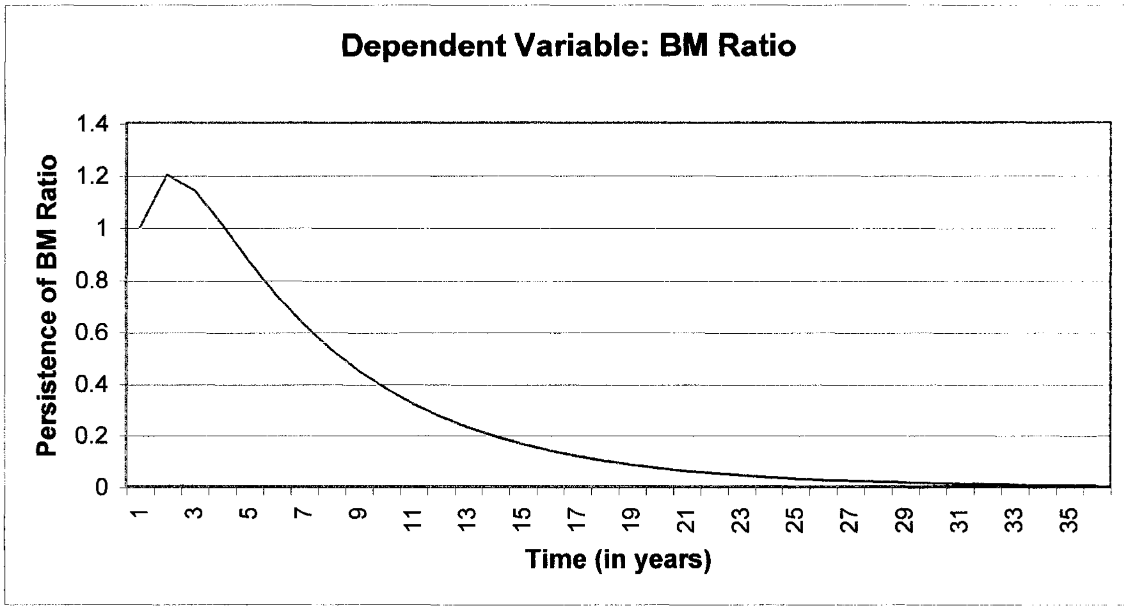


Figure 3D.1: Unit Root Check of the Dependent Variable with Two Lags

In addition to the standard Dickey-Fuller test to determine the possibility of a unit root, we can also perform a Wald test on the addition of the two lags and set this equal to zero. This leads to inconclusive results since the probability is greater than 0.1.

Finally, regressing the twice-differenced bank-market ratio on the rest of the variables returns the exact same results as the main model for the independent variables (the coefficients, standard errors, and p-values are the same) and for the rho, but the r-squared number differs (it is now 0.5561) and the two lagged dependent variables differ. These bear the following characteristics:

Table 3D.1 Statistical properties of the lagged dependent variables with a twice-differenced dependent variable

Explanatory Variables	**Coefficient (z-stat)**
$lnBM_{i,t-1}$	-.79*** (-5.5)
$lnBM_{i,t-2}$	.7*** (4.8)

The z-stats on the first and second lags are –5.5 and 4.8 respectively. These would almost surely satisfy a Dickey-Fuller test. However, the coefficients on the two lags of the dependent variable retain their opposite signs; where one is negative and the other positive. They again suggest a slow change in the dependent variable over time. Examination of the autocorrelation function and partial autocorrelation function across countries suggests that we can safely assume that the bank-market ratio exhibits a linearly declining trend, making the first-differenced model more appealing. Moreover, the two models' similar results with respect to the independent variables do not detract too greatly from the interpretation if indeed the second-differenced model is more appropriate. Thus, I present the first-differenced model in the main body of the chapter.

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[1] In appendex 3.A I provide regression results using bank assets/GDP and stock market capitalization/GDP as the dependent variables.

[2] See Thies (1997) for a discussion and application of the rural population and malapportionment as appropriate indicators of rural political power with respect to Japan.

[3] See Taylor (1996) for a discussion of various measures on international capital mobility for the period 1850-1992.

[4] With the augmented Dickey-Fuller test, I regressed the level of the DV on the level of the IVs and I then used the residuals with 1 differenced lag in addition to the lag of the residual on the right-hand side. From this, we can reject integration at the 5% level since the t-statistic = -3.57 while the 5% critical value as specified by Engle and Granrer (1987) is 3.17.

[5] In other words, it seems unlikely that a more banking-oriented financial system would lead to more political and economic power for labor and farmers.

[6] Indeed, this result leads us to question whether politics plays a more influential role than the legal system across other issue areas considered to be affected primarily by the legal system.

[7] These include Austria, Belgium, Denmark, Finland, Germany, Italy, Netherlands, Norway, and Sweden.

[8] Although LPP has a negative coefficient, this does not mean that it pushes the financial system toward markets, since this variable is interacted with the RPP variable. To discern whether it has the expected effect, we must look at how it changes while holding RPP constant, as in figure 3.11.

[9] I present data of the 19761-1997 period for the dependent variable, but because of independent variable constraints, my econometric tests cover the period 1976-1990.

[10] These include Austria, Belgium, Denmark, Finland, Germany, Italy, Netherlands, Norway, and Sweden.

[11] A Wald test for the null of a unit root when adding together the two lags of the dependent variable leads to inconclusive results regarding the rejection of the unit root.

Chapter 4

France: 1870-1990

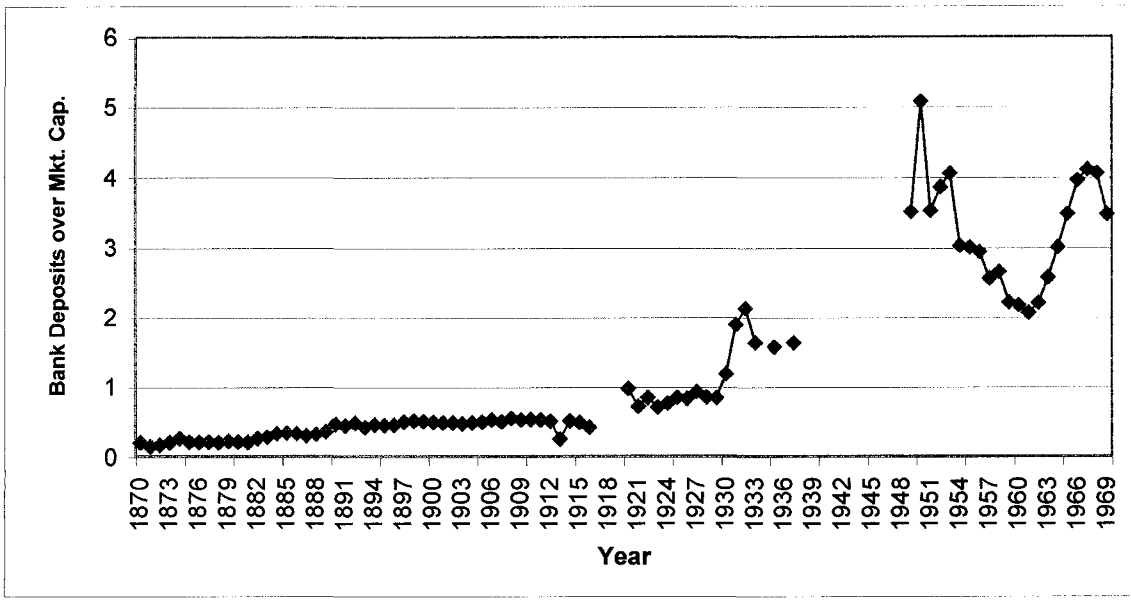
Why did France shift from a reliance on securities markets prior to WWII to depending primarily on banking finance in the post-war era? To summarize the findings, large firms and wealthy landowners wielded the most political power in the Third Republic, 1870-1940. This led to a limited number of agricultural banks catering to the demands of the rural elite, and to a heavy reliance on securities markets as the nation industrialized. With the Popular Front coalition of farmers, labor, and small business owners in 1936, legislation was passed to limit the influence of big business over the Bank of France, and to make it more responsive to this coalition by increasing lending directed to these groups; at this time, the Bank played an important role in financing business. The legislation was largely ineffective however. After World War II, left-wing political power surged since labor, in contrast to big business, was seen as opposing Hitler. Consequently, the Socialists nationalized the Bank of France, along with the largest commercial banks, in order to help them achieve high employment levels by controlling the conditions under which credit could be extended to firms. This laid the foundation for France's postwar reliance on banks. Small farmers and small business also achieved more political power after the war, which led to more banking facilities catering to their financing needs. In 1981, left-wing political power reached its highest level ever, and many more banks and firms were nationalized in order to achieve the left's employment objectives, and banks were once again heavily relied upon. Balance of payments deficits placed heavy strains on the government who was forced to privatize these enterprises starting in 1983; this also forced the government to bolster the nation's securities markets to keep the financing of French businesses at home. Because the left-wing has played an important role in French politics, France is a useful country to examine in order to understand its impact on the financial system. Because of the left's minimal influence on Japanese politics, Japan is a useful contrast.

The analysis of French financial and political history is broken into two parts. The first part offers a long-term overview of the dependent and key independent variables to see whether the correlation from chapter three holds up, and to identify key turning points that merit closer examination. In the second part, I examine three such periods in detail: (1) the Popular Front, 1936-38; (2) the immediate post-war period, 1944-46; and (3) the period of Socialist Party dominance in a time of rising international capital mobility, 1981-86. I also briefly summarize the Third Republic period preceding the Popular Front (1870 to 1936) as well as intervening periods, including the Vichy Government (1940 to 1944) and the Fourth and Fifth Republics from 1947 to 1981. Finally, I conclude.

Part I. Historical Trends of the Variables

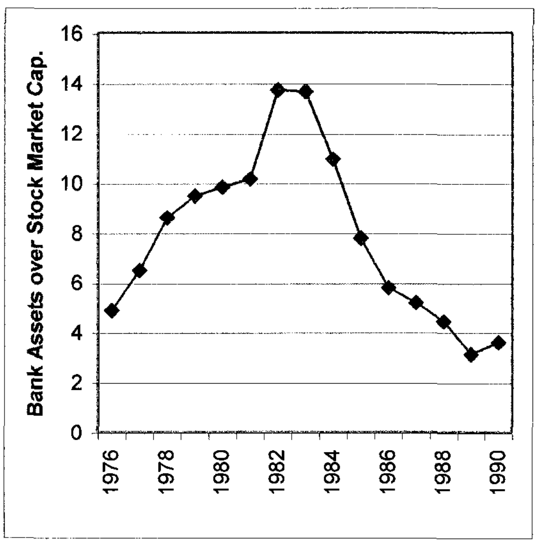
1. The Financial System

Prior to the 1930s, France relied heavily on capital markets as the conduit by which money flowed from savers to borrowers. The following figures illustrate the change over the course of the twentieth century.



Data Source: Michèle Saint Marc, 1983, Histoire monétaire de la France, 1800-1980, pp. 56-7, and Michèle Saint Marc, 1974, "Introduction aux statistiques monétaires et financières francaises (1807-1970)", in *Journal de la Société de Statistique de Paris*, 115 Année, No 4 – 4e Trimestre, p. 334. Data are originally from annual publications of the INSEE.

Figure 4.1: France, 1870-1969: Bank Deposits over Stock & Bond Market Cap.



Data Source for Figure 4.2: Beck, Demirguc-Kunt, and Levine, 1999. "A new database on Financial System Structure."
Note: examination of the trends for each variable comprising the ratio illustrate that neither one is completely driving the results; that is, the ratio is meaningful.

Figure 4.2: France, 1976-1990: Deposit Bank Assets over Stock Market Cap.

The breaks in the data correspond to the two world wars, when the market shut down. Because figure 4.1 depicts deposits rather than assets, the size of the ratio is slightly smaller than would otherwise be the case. Using a deposit measure is a reasonable indicator of banking reliance, however, since there is generally a strong correlation between it and a bank's total assets. Indeed, research by Gueslin (1992) confirms that the deposit measure offers a reliable guide to France's changing reliance on banks and markets.[1]

It is clear that France was more dependent on markets up until the 1930s; after WWII, banks played a more important role, but with widely fluctuating levels of dominance over French finance. Freedeman (1993, ch. 4) illustrates with several detailed industry-level case studies (including iron and steel, mining, engineering, electricity and gas, transport, and housing) which examine firms' financing sources for the time period 1865 to 1913, that "the issue of securities indicates a relatively efficient French capital market." For the period following World War I, the total value of bank credit has been estimated by Saint-Marc (1983). As a proportion of the national income, these credits dropped from 32 percent in 1913 to less than 20 percent in the 1920s (maximum 29 percent in 1929), to less than 18 percent in 1937, suggesting that self-finance and external finance via capital markets played increasingly important roles during the period. In particular, securities markets were important during the 1920s, while self-finance became more important during the 1930s.[2] Carré, Dubois, and Malinvaud (1975: 334) show the decline in stock and bond issues for corporations beginning in the 1930s:

Table 4.1: French Corporations' Stock and Bond Issues, 1896-1964
(percent of gross domestic product)

Year	Stocks	Bonds	Total
1896	0.9	1.1	2
1900	2.0	1.8	3.8
1913	2.6	2.9	5.5
1924	3.3	1.2	4.5
1929	5.7	2.6	8.3
1930	3.4	4.4	7.8
1938	0.6	0.3	0.9
1949	0.6	0.3	0.9
1954	0.6	0.8	1.4
1959	1.7	1.4	3.1
1962	1.4	1.2	2.6
1964	1.2	1.0	2.2

Note the dramatic change from 1930 to 1938, and its persistence to the end of the sample in 1964. Looking more closely at the total shares and bonds issued from the mid-twenties to the late thirties, we see that this figure quickly dropped from 1930 to 1931 and continued to fall until 1937.

Table 4.2: French Corporations' Stock and Bond Issues, 1925-1939[3]
(percent of gross domestic product)

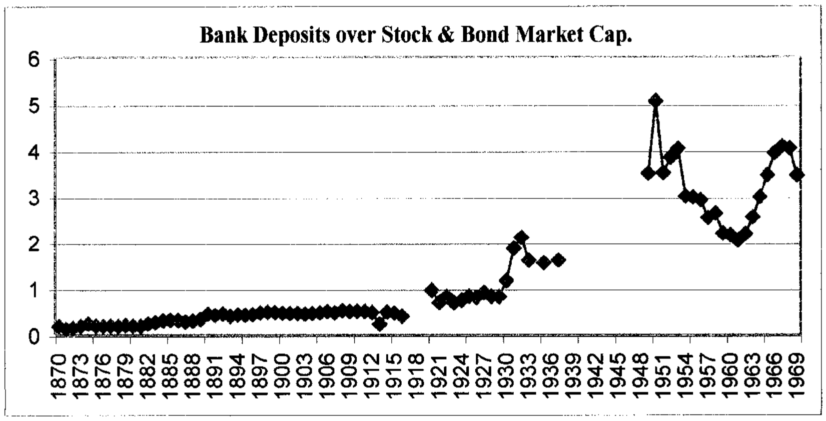
Year	Stocks	Bonds	Total
1925	2	.7	2.7
1926	2	1	3
1927	2.8	1.9	4.8
1928	4.8	1.9	6.7
1929	5.7	2.6	8.3
1930	3.4	4.4	7.6
1931	1.8	2.8	4.6
1932	1.1	4.4	5.5
1933	.9	2.6	3.5
1934	.7	2.3	3
1935	.8	1.5	2.2
1936	.5	1.2	1.7
1937	.7	1	1.8
1938	.6	.3	.9
1939	.6	1.2	1.8

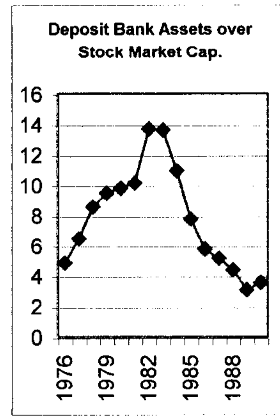
Examining the shifting dependence of banks in total relative to capital markets hides interesting patterns in French banking, however. Details on banking institutions catering to farmers, small business, and large enterprises will be discussed in the second part of the chapter.

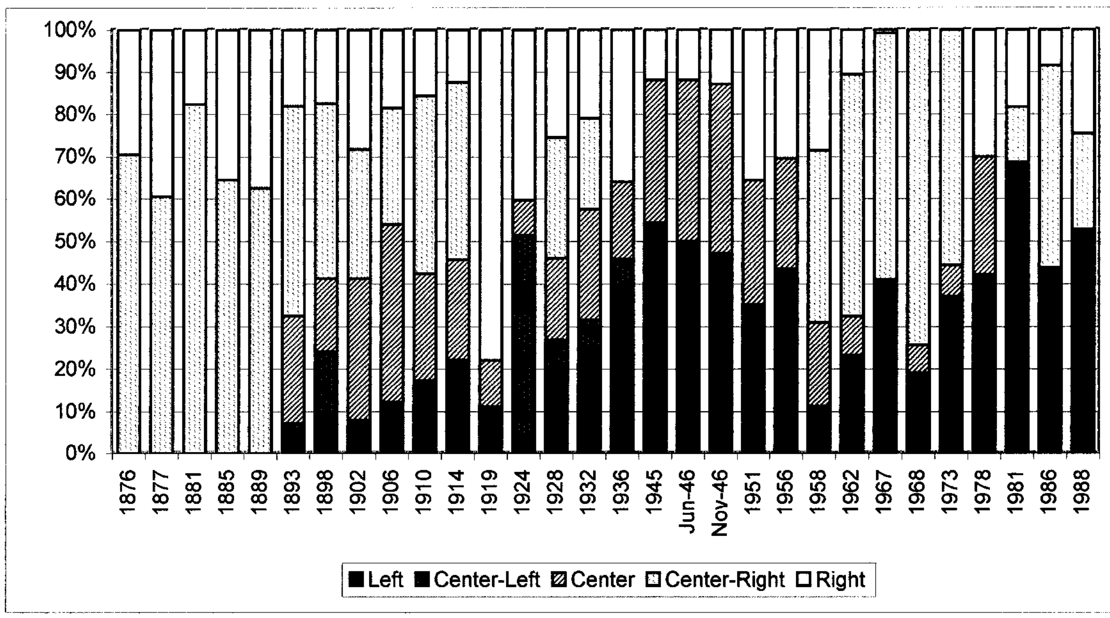
2. The Independent Variables

To determine whether the results from the statistical analysis in chapter three hold up when looking at France during the twentieth century, and to identify periods when the independent variables change considerably, I offer measures of them across time.

Comparing the changes in the structure of the financial system with the changes in the left-right composition of the National Assembly over the course of a century offers compelling evidence for a relationship between these two variables.







Source: Cole, Alistair and Peter Campbell, 1989, French Electoral Systems and Elections since 1789. Left=Socialists (PS), Communists (PCF), Federation of the left Democrats and Socialists (FGDS), Unified Socialist Party (PSU), Union of the left Socialists and Democrats (UGSD), Movement of the Left Radicals (MRG); Center-Left=Socialist Radicals, Cartel des Gauches, Socialist Republicans; Center=Radicals, Popular Republican Movement (MRP): 1945-58, Christian Democrats, Progress and Modern Democracy (PDM), Reformist; Center-Right=Moderate Republicans, Left Republicans, Independent Republicans (RI), Right-wing Radicals, Union for the New Republic (UNR), Democratic Union of Workers (UDT), MRP: 1962, Democratic Center (CD), Gaullists, Union of the Progressive Republicans (URP), Union for the Democratic France (UDF); Right=Conservatives, Republicans, Boulangists, Rallies/Liberals, Nationalists, Bloc National, Poujadists, National Center of Independents (CNI), Union of the French People (RPR), Front National (FN), Union of the group of the Center (URC).

Figure 4.3: National Assembly Elections, 1876-1988
(Percentage Seats to each Party)

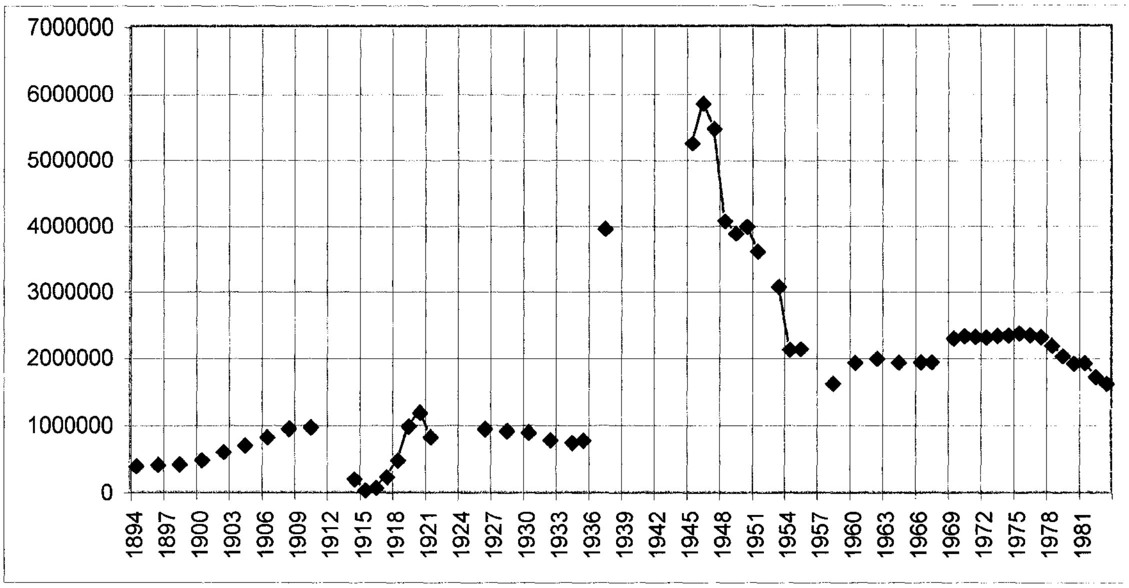
Of particular importance are the peaks in the bank-market ratio in the mid-to-late 1940s and 1982, which correlate with the peaks in left-wing political power in the 1940s and 1981. The unprecedented divergence between left-wing political power and the bank-market ratio in the mid to late 1980s accords with international capital mobility's growing influence. As noted in the prior section with regard to the 1930s, the upward move in the bank-market ratio is more a reflection of the decrease in stock market capitalization than an increase in banking services. Additionally, the increase in the bank-market ratio in 1967 and the increase in left-wing political power is spurious; each increases for reasons unrelated to the other. Gaullists pass legislation in 1965 and 1966, which increases the role of commercial banks in collecting deposits and financing business in the face of growing international competition. Left-wing political power remains less than the 50 percent necessary to effect any legislative change.

Looking at the National Assembly elections only offers a partial picture, however, since it neglects the role of the Senate and the president. One would expect the correlation to be stronger when the lower house has a greater share of the political power, as in the Fourth Republic, 1944 to 1958. In the Third Republic, 1870 to 1940, the lower house shared power with the upper house, which could veto unfavorable legislation coming from the lower chamber. And in the Fifth Republic, 1958 to the present, the National Assembly shared power with the Senate and the president, but with a majority of power residing with parliament with respect to domestic issues such as economic policy.[4] Because of the more democratic nature of the Senate during this period, it would more likely mirror changes in the National Assembly.

One might argue that war causes permanent shifts in the structure of the financial system, as observed after WW II. This argument explains short-term moves to banking, but does not explain secular changes (e.g., the US and UK both temporarily favored banking finance during WWII, but subsequently reverted back to a reliance on market-dominated finance). For example, France remained reliant on markets following World War I, in contrast to the period after World War II.

While the correlation between left-wing political power and the bank-market orientation is suggestive of a causal link, it does not permit us to conclude that one actually exists. We must look at the big changes in the political power of the left and examine whether the predicted regulatory actions consequently occurred. Thus, the figures are useful since they aid in identifying periods worthy of closer inspection, including: (1) the Popular Front, 1936-38; (2) Provisional Government, 1944-46; and (3) Socialist Political Dominance, 1981-86.

While left-wing political power seems to offer a powerful explanation for changes in the financial system, it is necessary to also examine labor union power, agriculture's political and economic power, and international trade and capital flows during the century. The following figure illustrates the change in the number of labor union members. While this is not as precise an estimate of labor's bargaining power as Garrett's measure, it nonetheless offers a reasonable guide to their changing negotiating strength.



Source: Mouriaux, René and Francoise Subileau. 1987. "Les Éffectifs Syndicaux en France, 1895-1985." Document de travail, CEVIPOF, Paris.

Figure 4.4: Labor Union Members, 1894-1983

The correlation between labor union's strength and the structure of the financial system is a loose one. That is, labor union membership increased in the late 1930s, and peaked immediately after World War II, corresponding to increasing regulations over the financial system. From the 1950s onward, however, there is not much of a relationship, suggesting that left-wing political power plays the more important role.

Figure 4.5 illustrates the proportion of France's rural population, from 1881-1962, which serves to illustrate the ideal proportion of legislators representing rural interests:

Source: INSEE, Annuaire Statistique de la France, 1966.

Figure 4.5: French Rural Population Proportion, 1881-1962

Table 4.4 depicts rural interests' actual representation in the National Assembly, for 1875, 1936, 1945, and 1956, and the deviation from their ideal representation, as shown by the average over-representation numbers:

Table 4.3: Malapportionment to the National Assembly, 1875-1956

Year	Total Representatives from Districts in Mainland France (A)	Total Reps. From Districts with >= 50% Rural Population (B)	Percentage of "Rural" Representatives (C)[a]	Percentage of Districts Overrepresented (D)	Average Overrepresentation of Rural Population Across All Districts (E)[b]	Average Over/Under representation of Total Population Across All Districts (F)[c]
1875	526			52.3%		
1936	592	345	58.2%	65.2%	11.5%	5.93%
21-Oct-45	522	295	56.5%	62.2%	9.6%	6.4%
2-Jan-56	544	314	57.7%	62.2%	10.8%	6.87%

Source: Cotteret, Emeri, and Lalumiere, 1960, Lois Électorales et Inégalités de Représentation en France, 1936-1960, p. 158 and Appendix no. IV.

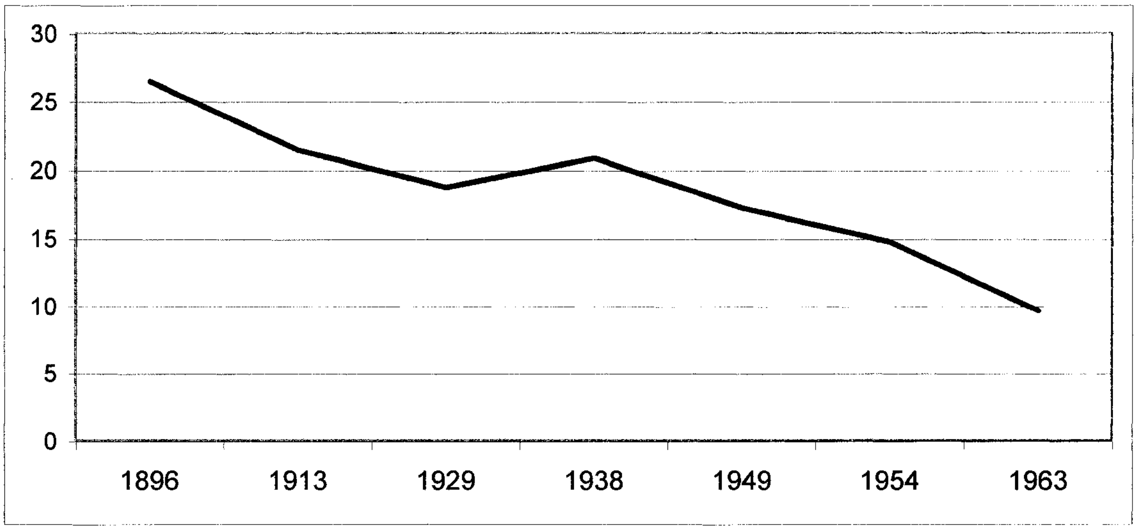
[a] This is calculated as (B/A)*100.

[b] This is calculated by determining the number of deputies that the department should have elected (reported in the text), and then multiplying this number by the percentage of the total population in the department that is rural (reported in the text) to get the ideal number of rural deputies for the department (usually a fraction, such as 3.57). This number is then subtracted from the number of deputies actually elected by the rural population in the department to yield the over or under representation for each department in terms of the number of deputies. Take this number and divide it by the ideal proportion of rural representatives for the department to obtain the percentage over or under representation for each department. Finally, sum across all departments and take the average to obtain the average over representation number (it could be under representation if the number were negative, but it is positive).

[c] This number is calculated by taking the average percentage over or under representation for each district (i.e., with regard to the number of deputies merited by the total population in the district), and then summing across all districts and taking the average. The calculation is very similar to column E, but with regard to the entire population in each district, not adjusting for the rural population.

We see that a majority of representatives to the National Assembly came from districts where over half of the population was rural. The percentage of districts overrepresented tells us that there was a consistent bias in favor of districts with a population less than the median. But this is not as insightful as the last two columns, which indicate the average level of overrepresentation of the rural population and the entire population. These last two columns show a consistent bias in favor of rural areas. The last column corresponds more closely to the numbers used in the statistical analysis in chapter three, and in this case, suggest that the measure is too conservative since the rural overrepresentation numbers are nearly twice as high on average; however, it would be very difficult to get data of this sort across all the countries for the sample period. Nonetheless, the data confirms the necessity for adjustment of the rural population data in chapter three since the electoral system rules magnify their representation in the legislature. But the main point from table 4.4 and figure 4.5 is that rural interests comprise a significant share of the National Assembly during the first half of the twentieth century.

Figure 4.6 illustrates agriculture's contribution to the national economy which is high at the beginning of the century and declines as time passes, except for a small blip in 1938:

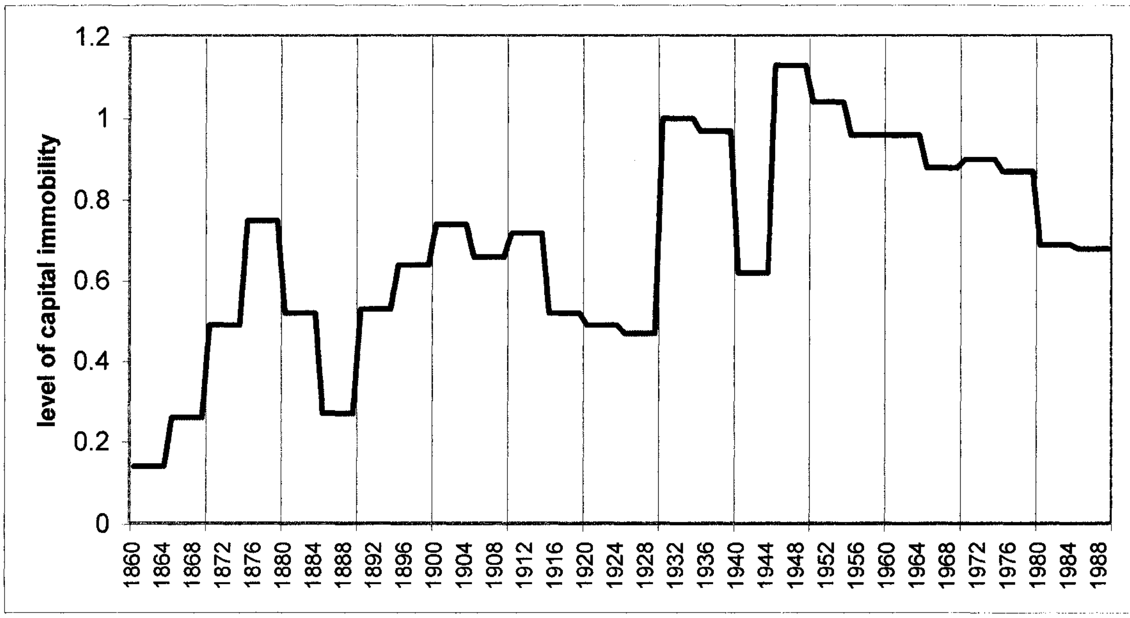


Source: Carré, Dubois, and Malinvaud, 1975, p. 518.

Figure 4.6: Agriculture as Proportion of Total National Production, 1896-1963

Given rural representation strength and agriculture's sizable contribution to the nation's economy for the period up to 1936, we might expect the financial system to be more banking-oriented. The next section will show that only the rural elite, who had seats in the upper chamber, wielded political power, and they received the financing that they desired while peasant farmers, primarily represented in the lower chamber, did not.

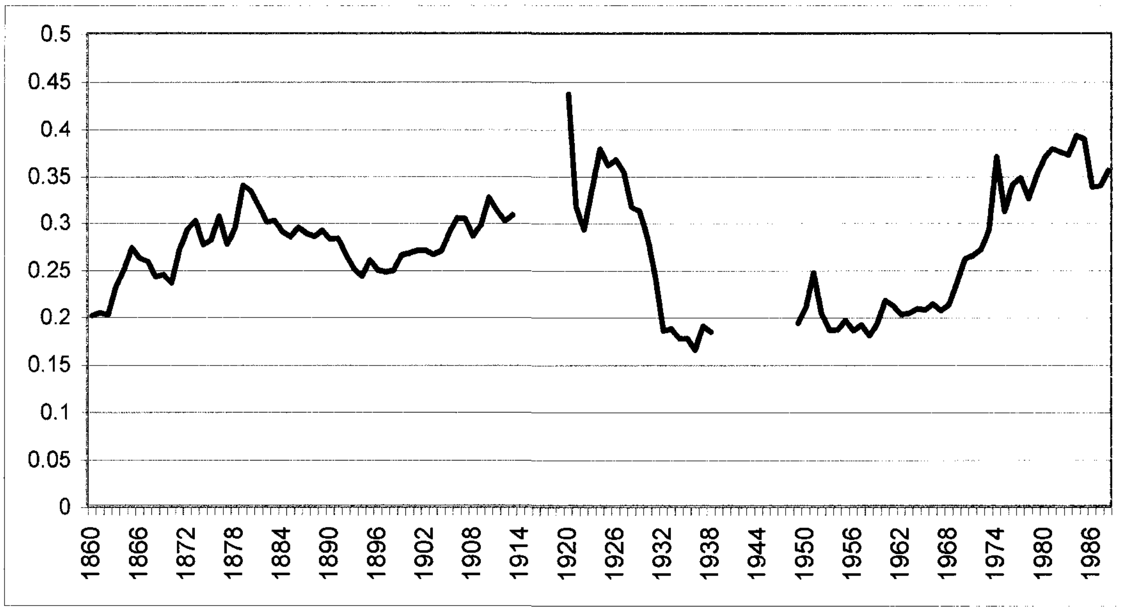
Figure 4.7 illustrates systemic capital mobility over the period 1860-1988 (the figure actually displays increasing immobility as reported by Taylor, 1996). It is clear that higher levels of capital immobility correlate with France's more banking-oriented financial system in the post-World War I period; specifically, the period 1930-1980 has relatively higher levels of capital immobility.



Source: Taylor, 1996. "International Capital Mobility in History: The Saving-Investment Relationship." Note: The figure illustrates the changing value of the coefficient in a time-series model for the Feldstein-Horioka test, with Investment/National Income on the left hand side, and Savings/National Income on the right hand side. Taylor uses annual data from 1860 to 1990 for 12 countries important to international capital flows.

Figure 4.7: Systemic Capital Mobility (Feldstein-Horioka Model), 1860-1990

The fluctuations in the period prior to World War I do not have as clear a correlation. Before making any judgments, we should also look at France's level of openness.



Source: B.R. Mitchell, International Historical Statistics: Europe, 1995.

Figure 4.8: Openness in France, 1860-1988
openness=(exports+imports)/GDP

Prior to World War I, France appears to be relatively open, in comparison to the 1930-1970 period. Systemic capital mobility was similarly high, on average. One might argue that capital and trade flows were sufficiently high throughout the prewar era to make the fluctuations in the level of openness have a negligible effect on the financial system; that is, France was forced to manage its macroeconomic policies carefully during the entire prewar period, and therefore was unable to offer large subsidies to firms via banks, forcing it to depend on capital markets. This may be true, but there is also a critical role played by domestic political actors. As Gourevitch (1986) cogently demonstrates, openness is determined by conflicts among domestic political actors. This chapter also seeks to demonstrate that those forces favoring openness (i.e., France's capital intensive industries, in which it had a comparative advantage relative to developing countries in the pre-World War I period) also preferred securities markets in the prewar era. Thus, openness is observationally equivalent with a heavy reliance on securities markets; but both were causally determined by large firms' political power. For example, the next chapter, on Japan, will illustrate that prior to World War I there was a far weaker connection between openness and market-dominance, but that markets nonetheless prevailed for corporations' external financing needs.

3. Summary

The evidence spanning twentieth century France corroborates the statistical findings from chapter three with regard to the strong correlation between fluctuations in left-wing political power and the bank-market orientation of the financial system. The evidence regarding labor's effective bargaining power also mirrors the statistical findings in that there is a looser connection between higher labor power and a more banking-oriented financial system. The economic power of agriculture seems to be of little importance relative to these other variables, which also matches the statistical results; that is, despite a great reliance on agriculture for France's national production prior to 1940, the country relied heavily on securities markets. Farmers' political power also seems unimportant, however, closer examination in the remainder of the chapter will yield a clearer explanation of this puzzle.

Increasing international capital and trade flows have a long-run correlation with a greater reliance on capital markets. The importance of international capital mobility in the contemporary period corresponds to the statistical results, although in the French case, capital mobility doesn't clearly alter the financial landscape until the mid-1980s, while the quantitative tests tell us that capital mobility has a statistically significant influence back to the mid-1970s. The remainder of the chapter seeks to identify the key causal mechanisms leading to market or banking dominance in France.

Part II. Detailed Historical Analysis

The second part of this chapter is broken into four sections: (1) the Third Republic, 1870-1940; (2) the Vichy Regime, 1940-1944; (3) the Provisional Government, 1944-1946; and (4) the Fourth and Fifth Republics, 1946-1990. For the discussions regarding the Third Republic, and the Fourth and Fifth Republics, I describe the structure of the political institutions in order to understand the distribution of political power among the relevant interest groups. As explained with regard to the electoral system in the theory chapter, political institutions often privilege particular groups at the expense of others. This is also true for the institutional structure of government; political power may be distributed unequally among the lower house, upper house, and the executive. It is necessary to analyze these institutions to understand which groups have the most influence on policy outcomes and their enforcement, as well as to clarify the delegation power (i.e., principal-agent relationships). For example, although the Ministry of Finance may be directly responsible for implementing policy and shaping the structure of the financial system, it usually operates within policy boundaries set by the legislature.[5] Thus, understanding the unique attributes of France's political institutions is crucial to determining the political power of the key actors: big business, labor, farmers, and small firms.

1. The Third Republic, 1870-1940

Political Institutions and Interest Group Political Power

To determine which actors had the most political power (i.e., groups which can propose, veto, and enforce legislation), it is necessary to examine the political institutions of the Third Republic. I discuss: (1) the Chamber of Deputies, also known as the National Assembly in the postwar period; (2) the Senate; and (3) the Executive: the President and the Ministry. Because the lower house (the Chamber of Deputies) had negligible political power during the Third Republic compared to the Senate, it is not helpful to examine the effects of the electoral system (which were only used for the Chamber) in isolation from the structure of the political institutions. So I focus on the distribution of power among the institutions.

The Third Republic was dominated by the parliament, which was comprised of the Chamber of Deputies and the Senate, with the Senate having the clear upper hand.[6] The key question for this analysis is which groups had the most influence on Deputies and Senators? Big and small business, as well as farmers, had the greatest influence on Deputies during the Third Republic; big business and large landowners were the most powerful in the Senate. Deputies' ties to big business arose from two sources. First, Deputies generally came from a privileged background; looking at their profiles in 1877 and 1885, for example, 89 percent came from the same landed, business, and professional categories.[7] The second reason Deputies relied on business was for financial assistance with their reelection efforts (Gildea, 1996: 14). Despite the bourgeois nature of the Deputies, they were paid very little (the same as the salary of a tax inspector). And because party cohesion was almost nonexistent, they received little money from their party to fight elections, making the cost very high. Given the huge bills they had to pay, they were very attracted by the offer of funds or directorships by financial, industrial or colonial enterprises which were themselves seeking contracts and concessions from the government.

Farmers and small business comprised a significant and important portion of the electorate. Deputies relied on their votes and would seek to distribute pork to them (and to businessmen) to curry their support. Labor did not emerge as an influential constituency until after World War I, and they did not acquire real political power in the Chamber until 1936, with the Popular Front.

The Senate was designed to insulate the political system from the universal suffrage of the Assembly. Senators were elected indirectly by mayors and councilors of departmental and arrondissement assemblies, ensuring that they were elected only by the privileged. Wealthy landowners were over-represented in the Senate. Big business also had considerable influence through their direct financial contributions to Senators and through the increasing influence of the growing number of wealthy industrialists. Small business and small farmers had almost no influence in the upper house.

The Senate could veto any legislation passed by the Chamber, and could also delay legislation indefinitely. Similarly, the formation of ministries was initiated by the Chamber, but the Senate held the power to defeat them. The lack of party cohesion further limited any sense of duty to vote with their counterparts in the Chamber.[8] In sum, the rural elite and powerful business interests had the greatest influence on the Senate.

Since the Senate held a veto on all bills initiated in the Chamber, the rural elite and big business acted as a veto-gate on the lower house's more populist legislative initiatives.

The president was elected indirectly by a joint session of the Senate and Chamber for seven-year terms. The president chose the president of the council of ministers (the technical name for the prime minister). The president could also influence the composition of cabinets (ministries). Ministries were responsible to parliament, and had to command a majority there to survive.[9] Thus, the bureaucracy came under the control of the parliament, and of the Senate in particular, which meant that the Senate could control the enforcement of legislation.

One might reasonably expect big business to heavily lobby legislators in France's Third Republic. According to Anderson, however, the formation of pressure groups before 1914 was surprisingly low, especially for big business. The exceptions were coalmining and the iron and steel industries.

> The truth is that businessmen hardly needed pressure groups when the general atmosphere was so favorable to their activities. In the same way, the formal organization of agricultural interests was hardly necessary when most deputies represented rural constituencies and the needs of agriculture could be expressed through the ballot-box. The most articulate spokesmen of agriculture, however, were landowners and the highly capitalized farmers of northern France, and the French Parliament did remarkably little to help the ordinary peasant proprietor or the rural worker. There were no significant measures, for example, to end the abuses of métayage (share-cropping, under which the farmer was provided by the landlord with seed, livestock and tools as well as land, and had to surrender half the crop), *or to make agricultural credit more readily available*. (italics mine; Anderson, 1977: 84)

Additionally, the presence of so many Deputies and Senators sitting on boards of directors continually drew criticism, particularly by Socialist Deputies.

In sum, political power resided in the parliament, with the Senate having the upper hand. The Chamber could initiate policy, but the Senate reserved veto-power. The Senate almost exclusively represented the interests of the wealthy agricultural elites and big business, and was not bound to rural peasants, labor, or small businessmen since they were indirectly elected. With the use of its veto power, the Senate could block any legislation seeking to alter the status quo, which favored the rural elite and big business. Indeed, Kuisel remarks in his thoroughly researched book, *Capitalism and the State in Modern France* (1981), that "...the weak republic ended up under the thumb of the trusts," where trusts refers to the largest enterprises.[10]

According to the hypotheses in chapter two, several predictions can be made. First, when big firms have relatively greater political power than other interest groups, and they are competitive in comparison to large firms from other nations in their main markets, they will seek to bolster securities markets. Thus, given their considerable political power during the Third Republic, and their relatively competitive position with regard to most other European nations and their colonies, we should expect large firms to advocate legislation favoring securities markets. A second prediction regards labor, who prefers banking finance for large firms. Given their relatively limited political power until the Popular Front in 1936, the financial system will not be dominated by banking finance, although they may press for it. Small firms and peasant farmers likewise lacked political power during the Third Republic until the Popular Front, and as hypothesized, we can expect few banking facilities that cater to their financing needs. Because wealthy landowners did exert political influence, rural credit facilities may be created for this select group. Although wealthy rural elites prefer banks, and may exercise considerable political influence, they would not need a large proportion of total national financing in order to satisfy their demands since they are more land-intensive than capital-intensive. Big business, on the other hand, would require a far greater share of total available financing because of the considerable extent of capital-intensive industrialization occurring during this period.[11] Overall, we can expect the financial system to be dominated by securities markets because of large firms' demand for cheap finance, and because of their disproportionate political power.

Farmers

During the Third Republic, farmers were divided in terms of their political power: peasant farmers lacked it; large landowners had it. According to the argument in chapter two, when farmers have more political power, the financial system will become more banking-oriented. Thus, we should see more banking institutions which cater to those farmers with political power (the large landowning elite).

The most important feature of the Third Republic economy was the rapid industrialization movement. From the mid-nineteenth century up to the 1930s, the national supply of credit went increasingly to firms participating in the industrial revolution (Gueslin, 1978: 29-44).[12] Consequently, farmers were facing higher borrowing costs. To remedy this problem, the Law of November 5, 1894 created a nation-wide banking institution devoted to agricultural credit, which formed the foundation for the Crédit Agricole. Since the beginning of the Third Republic (and for 50 years prior to the formation of the Third Republic with the Crédit Foncier organized under Louis Napoléon to finance mortgage loans backed by a state guarantee[13]), discussion had occurred regarding the formation of an agricultural credit institution to help farmers get access to capital, and also to help them deal with unforeseeable natural calamities such as worm and insect infestations, phylloxera which hurt wine-makers, drought, and excess humidity (Henry and Regulier, 1986: 6).

One of the key problems with passing a law devoting capital to agriculture is that farmers would not have sufficient qualifications to establish credit and get loans, especially peasant farmers (Henry and Regulier: 9).[14] Studies conducted by the Minister of Agriculture to evaluate the effects of the 1894 law in 1896 and 1900 found that credit was primarily granted to the wealthy farmers since they could more easily guarantee repayment of the loan, and banks could more easily evaluate their creditworthiness (Henry and Regulier: 17). Thus, with the passage of the 1894 law, the rural elite successfully alleviated their initial credit crunch caused by growing industrialization and worsened by unforeseeable natural calamities; peasant farmers were left behind.

Agricultural elites' used their political influence to great effect at the turn of the century. The number of regional banks grew from 9 in 1900 to 98 in 1913, local branches grew from 87 in 1900 to 4,533 in 1913, and the number of bank accounts at these local banks grew from 2,175 in 1900 to 236,860 in 1913. The laws of 1899, 1906, and 1910 permitted the state to advance (i.e., redirect) money to the regional agricultural offices; the total advances from the state went from 612,000 F in 1900 to over 93.9 million F in 1913, comprising 45% of the total resources of the regional agricultural offices in 1900 and 74% in 1913.[15] Clearly, agricultural interests were exerting considerable influence over the state's finances.[16] Considering the very high growth in the number of regional banks and local branches, it is surprising that only 2.9% of the active male agricultural population were members of one of these facilities in 1910 (Gueslin, 1978: 253).[17]

Throughout the 1920s, competition for the rural vote in the Chamber of Deputies between the conservative right and the republican center-left fueled the spread of farm organizations in France.[18] In 1920 the government consolidated the national agricultural credit system under the Caisse Nationale de Crédit Agricole, thereby increasing the availability of agricultural credit and sparking the creation of new agricultural cooperatives with the law of August 5, 1920.[19] This new institution gave agricultural finance a centralized national office, linking local and regional offices.

By 1921, the Bank of France had granted the Crédit Agricole 347.5 million francs. Additional 500 million franc grants for medium-term agricultural loans were made by laws passed in 1928, 1931, and 1932. 250 million franc grants for long-term agricultural loans were also made as a result of legislation in 1929 and 1932, and transferred to the Caisse Nationale de Crédit Agricole by the Bank of France. From 1928 to 1933, credits granted by the government represented around half of the resources used by the Caisse Nationale de Crédit Agricole for their loans.[20] It should be stressed that the Bank of France played a key role in this regard, and did not act simply as a conventional central bank. Large landowners were the primary beneficiaries of this largesse.

But in terms of France's overall financial system, agricultural credit constituted a small fraction of total financing during the Third Republic. Examining the volume of lending by commercial banks, which were primarily involved with funding big business, with that of the Crédit Agricole illustrates that agricultural finance had a small impact on the overall bank-market orientation of the French financial system.

Table 4.4: Financing of Big Business and Farms (in millions of francs)

	Commercial banks (1)	Crédit Agricole (2)	(2)/(1)
1913	13400	79	0.6%
1920	26000	189	0.7%
1929	70000	1873	2.7%
1931	56000	2906	5.2%
1935	50000	3112	6.2%
1938	60000	5691	9.5%

Source: Gueslin, André, 1992. "Bank and State in France from the 1880s to the 1930s: the impossible advance of the banks" in *Finance and Financiers in European History 1880-1960*, (ed.) Cassis. Original sources: Saint-Marc, Histoire économique: R. Priouret, La Caisse des depots et consignations (1966); Teneul, Financement; Journal Officiel.

Recall that at this time France depended to a large extent on markets, making farmers' financing a very small proportion of total financing indeed. Thus, although rural elites created and bolstered agricultural banks because of their political power, financing directed to the rural sector comprised a small fraction of the French financial system.

Small Firms

With regard to small firms, I hypothesized that they prefer banks, and that banking facilities will increase as their political power increases. Likewise, when they lack political power, they will get few banking facilities. During the Third Republic, they lacked political power, thus, I expect that few banking facilities to cater to their needs.

Prior to WWII, small and even medium-sized firms were short of banking capital. One key factor was that local banks serving small and medium-sized businesses fell in number (Plessis, 1985). Competition from savings banks since 1875-81, from the big establishments (e.g., large commercial banks) from 1894, and from the Bank of France which had been seeking direct customers since 1897, all caused local banks to decrease their operations. Additionally, regional banks expanded their operations between 1900 and 1930. As the big establishments extended their branches from 1894 onwards, regional banks did the same from 1900 on. From 1900 to 1923, the number of outlets available to the eight main regional banks in the north increased from 24 to 364. As the major establishments had already encountered, however, the greater geographical spread created difficulties in having sufficient information about local businesses, and a need for higher levels of security and liquidity (i.e., more conservative lending criteria and higher deposit-lending ratios) (Lescure, 1995, 315-25). Consequently, these regional banks wound up focusing on the larger enterprises.

In May 1911, an extraparliamentary commission was instituted "to study the banking structure in France and search for ways to enable it to provide improved credit facilities for both medium and small commerce and medium and small industry."[21] In 1913, the commission crafted a bill which would "simply extend to commerce and industry the (much more generously endowed) facilities that already existed for agriculture, which had been created almost twenty years earlier".[22] As a result of this study, People's Banks (cooperative banks) were reorganized in 1917 in order to provide additional short-term personal credit for small commercial and industrial firms. In 1919, the Crédit National was created to provide medium-term credit for small and medium-sized industries.[23]

Nonetheless, small firms had difficulties getting the financing they needed. According to Plessis (1956), the Popular Bank of Montrouge (a People's Bank) catered to the largest segment of the small and medium-sized local firms. The amount of credit directed to small firms by the popular banks was "a narrowing of the objectives of the

1917 legislation" (Lescure, 1995, 323). The Crédit National also offered only a small fraction of its total available financing to the smallest firms. In the 1920s, firms employing fewer than 100 people received credits amounting in value to only 29.5 percent of those granted by the Crédit National. The very smallest, those with 20 or fewer employees, received only 2.4 percent. Part of the problem was that the legislation stipulated that the maximum total credit that could be granted to a firm could not exceed 30 percent of its net assets. Small firms relied primarily on their industrial assets (land, buildings and equipment) to secure a loan, but the liquidation value set upon such items was usually between 33 and 40 percent of its current value. This further restricted the lending amounts, which were often judged to be "insufficient for a useful loan" (Lescure, 1995, 324). Additionally, the failure of mutual guarantee companies, which were to guarantee advances made by the People's Banks, and the abandonment of auxiliary shareholding banks originally intended to facilitate the guaranteeing of Crédit National loans, hindered these intermediaries from establishing local facilities that would overcome informational barriers, and thereby facilitate more lending to small businesses (Lescure, 1995, 325). While incomplete in terms of assessing the total lending available to large and small firms, it is nonetheless useful to look at the financing of large business conducted through the commercial banks relative to that of small firms through the Crédit National to get a sense for the importance of these actors to the French financial system during the Third Republic.

Table 4.5: Financing of Big and Small Business (in millions of francs)

	Commercial banks (1)	Crédit National (2)	(2)/(1)
1913	13400	--	0%
1920	26000	31	0.1%
1929	70000	527	0.7%
1931	56000	800	1.4%
1935	50000	997	2%
1938	60000	1181	2%

Source: Gueslin, André, 1992. "Bank and State in France from the 1880s to the 1930s: the impossible advance of the banks" in *Finance and Financiers in European History 1880-1960*, (ed.) Cassis. Original sources: Saint-Marc, Histoire économique: R. Priouret, La Caisse des depots et consignations (1966); Teneul, Financement; Journal Officiel.

Even if financing conducted by the People's Banks were added to the Crédit National column, it is certain that small firms would still constitute a small fraction of total lending in the French financial system. Recall that the financial system was relatively more reliant markets at this time, making small firm financing an especially small fraction of the French financial system during the Third Republic.

Big Firms

Since small and medium-sized firms predominantly seek financing via banks, the very existence of stock and bond markets (and their importance to the financing of large firms at the turn of the twentieth century) suggests that large firms must have some preference for them. According to the theory, large firms will prefer markets unless they are uncompetitive in their main foreign markets. Because large firms were very politically powerful during the Third Republic, and they were relatively competitive in comparison to other industrializing countries, France would be likely to develop a market-oriented financial system.

Freedeman (1993) surveys selected sectors in France prior to World War I to illustrate that securities markets played an important role in firm financing. During this period, not only were measures taken to bolster the securities markets in their own right, but corporate governance rules were altered to allow firms to more easily raise capital on the securities markets. That is, markets were bolstered in ways external *and* internal to the firm.

The law of 1867 formed the basis for the organization of French companies for the next hundred years.[24] By repealing the Commercial Code of 1807 that subjected the founding of a corporation to the consent of government, the new law permitted the corporate form of business organization (i.e., limited liability with a board of directors and shareholders able to influence management) without undergoing the lengthy process involved in government authorization.

Treaties promoting freer trade with Britain and Belgium in 1857 and 1862, which both possessed more liberal laws (i.e., easier rules for raising capital), necessitated the liberalization of French law as companies threatened to relocate or to start-up in these neighboring countries. Consequently, in 1867, the government ended the need for Sociétés Anonymes (SAs) to obtain government authorization. The initial result was an immediate rise in the creation of SAs from an annual average of 14 for the period 1842-1866 to an average of 219 per year for the period 1868-1878. Many of these firms may have been medium-sized, or even small-sized enterprises, but the preponderance of investment capital went to the large firms. The annual fluctuations of the formation of SAs correlate with the fluctuations on the Bourse, with a one-year lag. This lag is accounted for by the time it took to plan and to promote an SA. The ease with which SAs could be founded sustained the boom of the late 1870s and early 1880s. A distinguishing feature of this boom was the central role played by Parisian and regional stock exchanges (Freedeman, 1993: 5-14).

The remarkable level of influence of big business on the government, and the government's consequent support of securities markets, is further revealed with legislative action, and inaction, regarding changes in corporate governance laws after the stock market crash of 1882. The spectacular failure of a major investment bank, the Union Générale, symbolized the end of a speculative boom that began in 1879. The founding of SAs on such an unprecedented scale fed the boom. In 1879, 511 SAs were founded, 797 in 1880, and 976 in 1881.[25] Approximately 80% of the capitalization of all enterprises were for SAs. For all of France the nominal capital of newly founded SAs in 1881 topped any year for the period 1868 -1914. Additionally, the number of new companies quoted on the Paris Bourse doubled between 1877 and 1881. The demand for capital during the boom was further swollen by existing corporations increasing their own capitalization rates.

Shortly after the end of this bubble, an extraparliamentary commission was convened to revise the law of 1867. The committee drafted a bill that satisfied the critics of the 1867 law, but which was anathema to liberals and to sections of the business community since it would greatly hinder the ease with which firms could raise capital, and would increase business owners' liability to investors. The bill first went to the Senate since Bozerian, who presided over the extraparliamentary commission, was also president of the Senate's committee to examine the bill. It passed the Senate on November 29, 1884 without any significant changes.

More than a year elapsed between the vote of the Senate and the introduction of the bill into the Chamber of Deputies, which offered time for the public's anger to subside. Recall as well that big business was an important interest group to Deputies' political careers. In January 1886, the bill was referred to a committee of the Chamber headed by Maurice Rouvier. Meanwhile, the government solicited the opinions of outside experts. The liberal/pro-big business view was best expressed by Antoine Jacquand, a lawyer and businessman, and a former president of the chamber of commerce of Lyon which, along with Paris, endured the greatest hardships from the mania. Jacquand strongly criticized the large number of provisions which could result in a company's being declared null, and against the financial liabilities and special criminal penalties that could be incurred by founders and members of boards of directors. The effect of such a law would "drive savings into foreign securities...while our large financial industrial enterprises became the prey of adventurers who offered no guarantees other than their audacity and effrontery."[26]

In the Chamber of Deputies, only one member of the Chamber's committee favored the bill in the form passed by the Senate; overall, the committee aimed to soften the Senate's harsh recommendations. The elections of 1889, however, brought the legislation to an end before the committee took any action.

Just before the elections of 1889, the movement for liberalization received a setback with the failure of de Lesseps' Panama Canal Company and the collapse of Secretan's attempt to corner the world's copper market, which brought down not only the Société Industrielle et Commerciale des Metaux, but the Comptoir d'Escompte, one of France's largest deposit banks. To avert a general banking crisis, Maurice Rouvier, now

Minister of Finance, met with Parisian bankers to find a way to save the Comptoir d'Escompte. The timely intervention of Rouvier and the Bank of France averted what might have become a serious financial crisis. To many, these latest casualties again pointed to certain weaknesses in company law, and dramatically illustrated the need for restrictive legislation.

Fears that such legislation would be passed appeared in 1890 when a new committee of the Chamber began to consider the Senate's bill. These fears soon proved to be unfounded, however. As with the 1886 committee, most of the members of the new committee were opposed to it.

The short bill that eventually emerged, with some revisions in the Senate, became the law of August 1, 1893. The law, which dealt with some of the more pressing problems, contained *both* liberal and restrictive provisions. No further reform in company law occurred for almost a decade. Clearly, business had won the political battle, and retained relatively liberal laws that permitted them to use domestic capital markets for their external financing needs.

After World War I, the Confédération Générale du Patronat Français (CGPF) was formed to represent the interests of big business to government, in reaction to the growing political influence of labor; small and medium-sized enterprises had almost no representation up until 1936. Duchemin was the president of the CGPF from 1926 to 1936, and in his book he outlined the philosophy of the CGPF which informed his annual addresses to parliament.[27] While many issues caused divisions among firms from different sectors (e.g., especially regarding international trading arrangements), a key overriding philosophy governing the CGPF was the commitment to economic liberalism.

Big business sought to ensure that the 'classical laws' of laissez-faire governed the structure of the French economy. Liberty was safeguarded as long as the government refrained from controlling business and business agreements. This equated to ensuring that access to capital remained free from any government imposed restrictions or manipulation, such as regulations affecting access to securities markets, as well as control over lending arrangements through various credit granting facilities (i.e., banks). While Duchemin articulated the interests of big business only after labor became a real political threat, he was merely expressing the sentiments that business leaders shared for many decades prior to the formation of the CGPF.

In sum, large firms' domestic political power played the critical role in France's market-oriented financial system during the Third Republic. International trade and capital flows were important to the extent that they gave large enterprises a credible exit option, which increased their influence in government. Balance of payments issues, and associated macroeconomic policies that kept debt low, were not central to the government actions affecting the financial system.

Labor

Labor political power, as represented by left-wing political parties, was minimal. Accordingly, the financial system should not become reliant on banks in a way that reflects labor's interests.

Prior to World War I, unions and left-wing political movements had sporadic, but mostly negligible influence on firms and government. At the end of World War I, labor activity and union membership surged. On December 16, 1918 the Confederation of

Workers (Confédération General du Travail: CGT) issued a statement of the changes it sought in its Minimum Program, which formed the major themes of the interwar years. With regard to the economy, this document primarily focuses on the objective of *dirigisme*. That is, "The working classes must manage the national effort" of reorganizing the economy by exercising "permanent" control over all branches of production.[28] While the document does not explicitly say that control over the allocation of credit, or of financial institutions, is how this will be achieved, it is nonetheless clear that this is a suitable option. The Program advocated nationalization of key industries, which was to be implemented not by the state alone, but by mixed public corporations, "administered by the qualified representatives of producers and consumers".[29] When possible, proposals for nationalizing the mines, the railways, and 'industrial monopolies' were placed before parliament during the 1920s.

Elections in 1924 brought the Cartel des Gauches to power in the Chamber of Deputies, a coalition of the Socialists, Radicals and some minor left wing groups; it was a center-left alliance since the Radicals were centrist. Because of the strength of the moderate members of the coalition, left-wing members were unable to push their policies through. However, the government did initiate the first 'mixed companies' in 1924 in the reacquired territory of Alsace: the Compagnie de Navigation du Rhin and the Chantiers et Ateliers du Rhin. The government owned a minority share in both enterprises and participated in their management along with representatives of private stockholders. However, no real change occurred with regard to the financial system since labor lacked sufficient political power. They would have to wait until the Popular Front government of 1936.

The Popular Front, 1936-38

The Popular Front was a temporary and defensive electoral alliance of those hit hardest by the depression: farmers, the middle class (including small business), and workers. This alliance included a coalition of Communists, Socialists, and center-left deputies, the most numerous of whom were the Radicals. I first assess the political power of each group as well as the coalitions formed among them, and then examine legislation that they supported affecting the structure of the financial system. I hypothesize that these groups will propose legislation that bolsters the reliance on banks in the French financial system: farmers will seek more rural credit facilities and/or an increase in available funds from established lending facilities; small business will also seek more local banking facilities and/or more available funds from established lending institutions; labor will push for control over lending arrangements to large firms either through direct or indirect means in order to improve working conditions and employment levels.

Actors' Political Power and Coalitions

The Popular Front illustrates how labor, farmers, and small business fought against big business through their representative political parties to alter the financial system. The following table illustrates the proportion of legislators from each political faction for the Chamber of Deputies following the 1936 election.

Table 4.6: Seat Distribution in the Chamber of Deputies, 1932 and 1936

	Chamber of 1932	Chamber of 1936	Difference
Communists	11	72	+61
Socialists S.F.I.O.	131	147	+16
Dissidents	37	51	+14
Socialist Radicals	157	106	-51
Other Deputies sympathetic to the Popular Front.		2	
Total for the Popular Front		**378**	
Other Deputies hostile to the Popular Front		6	
Moderate	120	76	-44
Center right or right	138	138	0
Total against the Popular Front		**220**	

Source: Dupeux, 1959, pp. 138-9.
Note: Dissidents include the Socialist and Republican Union (25 seats) and the Left Independents, the Party of C. Pelletan, the Frontist Party, the Party of Proletarian Unity, and the Party of the Young Republic (26 seats). Moderates include the Democratic Left and the Independent Radicals (32 seats), the Alliance of the Left Republicans and Independent Radicals (44 seats). Center right or right include the Popular Democrats (13 seats), the Independent Group of Popular Action (16 seats), the Group of Independent Republicans and Social Action and Independent Agrarians (38 seats), the Independent Republicans (12 seats), and the Group for the Republican Federation of France (59 seats). Deputies not affiliated with any of these groups accounted for the remaining 8 seats.

It would be simplistic to assert that there was a clear demarcation of farmers, labor, small firms and big business conforming to the partisan composition of the Chamber. The true political picture is more complicated. Divisions among these groups, and among small business in particular, considerably weakened the Popular Front in June 1937, with the defeat of Blum, when a confidence motion expressing support for the Daladier government saw the Socialists and Communists move into opposition to the Radicals, who survived in power with the support of the Right.[30]

With regard to electoral support for the Popular Front, farmers were divided. The peasantry, especially those from the center and southwest and from some of the northern departments, showed strong support for the Popular Front.[31] This resulted from the Popular Front's proposal to reform the grain market in order to ameliorate the low prices and chronic instability of that sector, and to create a Wheat Office which would be responsible for all wheat imports and which would control the internal wheat market.[32] Their support for the Popular Front waned after legislation was passed to these ends, and poor crops decreased supply and led to higher prices. However, many rural voters still favored right-wing candidates, and according to Wright (1964: 59) they outnumbered left-wing rural candidates by a two-to-one margin.[33] Part of this resulted from traditional religious cleavages and the associated party affiliations.

Support of the Radical Party was crucial for the Popular Front. Generally speaking, members of this party were comprised of "small independent proprietors, farmers, shopkeepers, artisans, fonctionnaires [minor civil servants], men of the liberal professions—that is to say, all those who live from their work, but work that they pursue as individuals; from their craft, but a craft that is distinctly theirs."[34] A large section of these voters were small business owners. Because this party encapsulated a broad range of people from the middle classes, there was a split among Radicals in supporting the Popular Front, as the foregoing table illustrates: small business owners tended to be more conservative since they favored the enforcement of property rights which placed them at odds with the Socialists and Communists; others tended toward the left since they would benefit from social welfare reforms. Radical support for the Popular Front clearly declined after the change in leadership in 1937, as illustrated by Warwick (1977), tilting the balance of the Chamber to the right. Indeed, the presence of the Radicals was essential for the Popular Front; their departure ended it.

The Radical Party began to rescind much of its support to the Popular Front in reaction to the great strikes of 1936, which were led by the Communists.[35] These strikes created a sense of fear among the conservative members of the Radical Party, particularly those who desired protection of property rights. Further Communist-led strikes to prompt intervention in Spain (to help the Spanish Republicans) caused a further split among right and left-wing Radicals, and ultimately strengthened the conservatives within the party.[36] These events permitted the right-wing elements of the party to move the Radicals away from the Popular Front in 1937, particularly the critical centrist members.

Labor was the most unified supporter of the Popular Front, though it too had divisions. These were largely over the extent of the reforms it sought, ranging from the more extreme versions of the Communists who sought state directed planning of the economy to more moderate Socialists who advocated a milder form of nationalization. Planning was a more direct form of government intervention in the national economy. It would transform the means of production and exchange into 'social property,' and would not indemnify owners. Nationalization, on the other hand, would remove industry from the control of the markets and make it a public service. It would remunerate owners since the capitalist framework would remain intact.[37] While Blum agreed with the principles of planning, he and the Popular Front coalition found it more politically expedient to advocate the latter option in order to garner the political support of the more moderate Socialist Radicals, and associated members of the growing middle class.[38] To 'sell' it to the public, they also called their program an 'anti-fascist' alternative to the status quo.

Big firms primarily supported the right, as expected.[39] However, these large firms and the CGPF played an important role in influencing small businessmen to distance themselves from the Popular Front. On the one hand, small businessmen were pushed away from supporting the Popular Front because of their growing resentment over the sit-down strikes which were aggravated by the unionization of labor even in small enterprises. Increases in wages and prices, which were inflationary,[40] resulted in credit and market difficulties for small business. There was also evidence that small firms were reluctant to accept new orders if they involved protracted negotiations with labor or trade unions.[41] On the other hand, big firms attempted to attract small business into their employers' organization (the CGPF) for the first time. Addressing a meeting of the CGPF, the new president, M. Gignoux (the successor to Duchemin), asked the delegates of big business "to withdraw from the control of the important trade associations and to leave a predominant influence to the owners of small and medium-sized enterprises, to whom big business will continue to provide advice and wholehearted assistance."[42] Vinen (1991), however, convincingly argues that statements of this kind were largely lip service paid by big business to smaller enterprises in order to move them to the right in order to stymie left-wing efforts at nationalizing the economy. The smaller enterprises may have realized this, but they already had incentives for disassociating themselves from the Popular Front.

It is nonetheless clear that the Radical Party played a key role in the Popular Front's rise and fall from power. And within the Radical Party, it appears that small business played a key role in tilting the political balance. Small 'peasant' farmers also played an important role in bringing the Popular Front to power; once their grievances were addressed their support also declined.

Although these groups may have had divisions in terms of supporting particular parties, these divisions may have receded when it came to voting on financial system legislation. For example, the rural elite may have voted against the Popular Front in the general election, but their representatives may have voted with the Popular Front for policies such as the creation of the Wheat Office, or regulation of the domestic wheat market.

The Senate's composition, which had elections in 1935, was not altered by the Popular Front surge. The upper house was still dominated by conservatives such as the rural elite and big business. Many bills approved in the Chamber, such as collective bargaining for farm workers and a modified form of the eight hour work day, relief for farm debtors, and the protection of cash tenants against unjust practices by landlords, were sent to Senatorial committees for further study, never again to see the light of day.[43] Big business and large landowners who dominated the Senate posed a considerable roadblock to the Popular Front's objectives. Given the political power of these various groups, we should see legislation proposed in the Chamber to bolster banking services, but with big business in the upper house leading the effort against it.

Legislation

In the two years prior to the Popular Front, members of the SFIO (the French Socialist Party) more explicitly discussed various possibilities for reorganizing the state's finances to deal with the depression and to achieve their more fundamental goal of redistributing national resources and improving working conditions.[44] Henri de Man, a Belgian socialist who constructed a plan based on his analysis of the German experience and adopted by the Belgian Labor party in December 1933, captured the attention of the French left. De Man identified finance capital as the common enemy: "An oligarchy of bankers held farmers and small businessmen … in tutelage."[45] Additionally, he argued that no more distributive reforms, such as higher wages or cheaper credit, were forthcoming without structural change, and that nationalization of key sectors should begin with the credit system.[46]

To achieve these ends, the Socialists proposed a Plan which would demand the creation of a National Economic Council, comprised of representatives of big business, workers, directors and employees of banks, and representatives of the state. This organization would be responsible for the direction of credit and, in particular, control of the Bank of France. Nationalization of credit was pivotal to the Plan: "The socialization of credit is the condition of industrial socialization."[47] And two leaders of the CGT, E. Lefranc and J. Itard, further remark:

> The nationalization of credit and the control of the banks…. the immediate effective control of key industries by the representatives of the collectivity and the salaried workers…. these two structural transformations are necessary for the economy of this country to leave the capitalist stage and are only possible with the distributive reforms requested by the CGT.[48]

Controlling these two aspects of the economy would give labor the ability to implement the *dirigiste* economy that it had long sought: "Control over credit, for the CGT, was the key to managing the economy."[49] In the mid-1930's, "nationalizing credit" meant expelling private interests from the regents of the Bank of France (the largest shareholders who chose the regents of the Bank of France were called the '200 families' and almost exclusively represented the interests of big business; Duchemin, for example, was a regent) and using the central bank to control credit and investment. It also meant setting regulations for private banks, nationalizing those credit institutions whose statutes were already semipublic, and expanding their activities.[50]

The Popular Front Program[51] included reforms regarding the banking profession, the sociétés anonymes, and the Bank of France.[52] With regard to the latter, the Program stated the following objectives: "Removing the credit and savings from the domination of the economic oligarchy, by the Bank of France.... Enlarging the power of the governor, under the permanent control of a council composed of representatives of legislative power, or representatives of executive power and of representatives of the large forces of organized workers and industry, commerce, and agriculture." With regard to agriculture, the Program sought to develop the Crédit Agricole and to support the agricultural cooperatives.

Legislative action regarding the financial system only occurred for the Bank of France. Many of the other proposed reforms never made it onto the legislative agenda (e.g., reform of the sociétés anonymes and the banking profession) likely because they would never survive the Senate. Thus, deputies, anticipating this, did not waste their time on such bills (except, perhaps, to demonstrate their commitment to such issues to their constituents). Popular Front representatives would have to wait until after the war for the conservative Senate to lose its power, thereby permitting the left to finally implement its agenda.

The Bank of France[53]

Revision of the statutes governing the central bank had become genuinely popular by 1936 because of its role in financing business and agriculture, in addition to its more traditional central bank activities. The bank had infuriated the left when it refused to help the Cartel des Gauches defend the franc in 1925-26. Left-wing writers had charted the family alliances of the bank's regents and propagated the myth of the '200 families'. After 1930 the bank had done little to attenuate hardship. It extended privileged credit to big firms but disdained small business and farmers and refused to help troubled local banks:[54]

> The Bank, it is said, has rested comfortably on its tradition. The discount is always more or less reserved for a limited and privileged circle. But today things are aggravated .... Farmers, artisans, and small businessmen are not ... obtaining the smallest amount of credit, and are finding that this even concerns the guarantees of access to credit in extremely difficult situations.... Who therefore receives the supply of credit, and offers the necessary guarantees for access to credit, other than those already found at the head of the important enterprises and given considerable amounts of capital?[55]

The Bank of France competed directly with private banks, which led to involvement in at least one major bank failure. As a champion of deflation, the central bank pursued a tight monetary policy and used its secret fund to influence the press. Above all, for a central bank to be in the hands of a hereditary oligarchy that shut out other interests and on occasion forced its will on the government seemed anachronistic and antidemocratic to the Popular Front interests.

Blum and his Socialist finance minister Vincent Auriol justified reorganization on the grounds that credit policy should serve the national economy; there should be an end to the bank's unrepresentative management and its discriminatory practices. But Blum and Auriol decided against nationalizing the bank given the opposition of the Radicals, who feared allowing the government to dictate monetary policy.[56] Instead the two Socialist leaders confined themselves to overhauling the bank's administration. They sponsored legislation that replaced the regents with a new council and an executive heavily weighted in the state's favor and democratized the shareholder's assembly. It was passed on July 25 1936 (the Blum government took office on June 6 1936 making this legislation one of the first to be passed). Only 77 Deputies, all from the right, opposed the legislation.[57] The Senate passed the legislation as a way to appease growing public anger, but prevented further legislation from altering other important and related functions, such as allowing "open market" buying and selling of securities, proscribing competition with private banks, or establishing an agency to monitor the money and credit markets. Because the prospect of getting more radical measures through the Senate was very unlikely, the Blum-Auriol team tabled any further action. Additionally, public support for the Popular Front's agenda was quickly declining. In the end, the reorganized bank changed its policies very little; for example, in 1936-38 discount policy was not liberalized. Although minor concessions were granted immediately after the Popular Front came to office, big business – via its political power in the Senate -- ultimately succeeded in stopping serious alterations to the French financial system. Nonetheless, within the next decade almost all the reforms recommended in 1936, including nationalization, would be adopted.[58]

2. Vichy France

In the late summer of 1940 the French economy, now in the hands of the Vichy Government, was in chaos. War factories had closed, putting almost two million people out of work. Another two million were in prisoner-of-war camps. The Germans had taken control of the Nord and Pas-de-Calais departments as well as Alsace-Lorraine, and they had disrupted economic activity by inserting a demarcation line between the occupied and unoccupied zones, obstructing the flow of commerce. The British blockade cut off trade and denied France access to essential industrial imports. For example, ninety percent of its textile raw materials and a third of its coal were imported before 1939. Gasoline was in short supply. Inflationary pressures were building to extreme heights. Heavy use of the transport network for German military purposes aggravated the disorder, as did German requisitioning of industrial stocks and products under the guise of winning the war against Britain.

To stop the deterioration of the economy, the Vichy Government enacted legislation creating the Comités d'Organisation (CO) on August 16 1940. The legislation was intended to assure that the French economy would survive the war and occupation. Management of the economy was necessary to bring order to the undersupplied and chaotic market. Additionally, managing the economy would facilitate the transfer of national resources to the Germans; others have argued, however, that the French took the initiative to manage the economy to ensure that they retained some measure of independent control in order to reduce German exploitation.[59] In any case, the CO for each sector was charged with regulating business operations; that is, not to administer the economy, but to organize it with the active participation of private employers.

It was necessary to include the banking sector in this new framework, which was accomplished with the statutes of June 13 and 14, 1941.[60] The legislation delegated responsibility to bankers to organize and monitor their profession through the Bank Control Commission as well as the Permanent Organization of Banks and Financial Houses, under the supervision of the Vichy Government. Much of the work carried out by these bodies provided the basis for the wider and more complete controls introduced after the liberation.

The role of war is not discussed in my theory. Instead, I focus on periods of peace, and consider the extent to which interest groups' political power alters the structure of the financial system. There is no doubt that crisis periods are of importance to national histories, however, the changes that occur during these moments do not persist unless the new political environment chooses to sustain them. For example, both the United States and the United Kingdom relied heavily on banks during WWII, however, both reverted back to securities markets after the war. Thus, to understand why a country relies on banks or securities markets during peace requires examination of interest groups' political power after a crisis ends.

3. The Provisional Government, 1944-1946

Conservatives and Socialists had different visions for postwar France. The neoliberal perspective was articulated best with Courtin's Program, which sought a return to the free market of the Third Republic. Socialists, by contrast, sought to manage national production to the benefit of labor. Each viewpoint would have serious repercussions for the structure of the postwar financial system. Ultimately, labor would win the political battle by a wide margin, and, according to the hypothesis in chapter two, France should become more reliant on banks than markets.

In the immediate postwar environment, popular opinion accused big business of aiding the downfall of the French Republic. This anti-business sentiment pervaded the first years of the liberation. Labor, by contrast, was seen as opposing the Germans, and was celebrated as defenders of the French Republic. Consequently, the most important feature of France's immediate post-war politics was the dominance of the left. André Philip's Socialist Program, advocating the nationalization of key industries including the banks and insurance companies and leading to the dominance of banking finance, was therefore adopted.[61] I first discuss the goals of the Socialists and Neoliberals at the end of the war, and then examine the measures passed by the provisional government affecting the financial system.

The Socialist Program

While there were several visions for placing the management of the economy firmly under government control, André Philip's had the broadest support, and for this reason de Gaulle appointed him the Comité Française de Libération Nationale Commissaire in charge of relations with the Constituent Assembly and the study of postwar problems. In January 1944 Philip created several study commissions that brought together representatives of the external and internal resistance. He packed the commission on economic problems with structural reformers from the left. General de Gaulle received the commission's report in July 1944 as the provisional government completed its preparations for its return to France.[62]

Philip pressed for structural reforms within six months of the landings since the fervor for change would peak with the beginning of the new republic. Philip proposed comprehensive planning (and Keynesian countercyclical policies) to sustain full employment and economic development. He contrasted this mode of state management with the style of the prewar parliament which had turned economic management over to experts in economic liberalism who "intervened only reluctantly in order to cure illnesses rather than prevent them, to salvage enterprises rather than organize them".[63] No unit of production lay outside state management:

> From the moment one admits the necessity of planning, private sectors are no longer possible because no element of the economy should escape the plan. Direction could be achieved by more or less flexible methods. Certain sectors could be socialized, others directed, and still others simply supervised. Nothing, however, would escape the impetus of governmental authority, which is responsible for the survival and grandeur of the nation.[64]

In a planned economy, he argued, certain producers were so important that they had to be nationalized so that the state could effectively control investment:

> Finally and in all cases, there is in a planned economy, certain highly essential productions which, by their importance and by their repercussions on the whole of industrial life, the state must absolutely assure the direction of if it wants to exert effective control on all investments.
>
> It is therefore indispensable that, upon the return to France, the state takes direct management of *all modes of land, sea, and air transport, of the mines, electrical utilities, iron and steel manufacturers, chemical producers, the insurance industry and the banks*. The socialization of these important sectors will permit the state to have a hand on the sufficient instruments for effectively controlling investments and assuring the direction of the rest of the national economy. (italics from the original)[65]

For directing the private sector, Philip advocated rejuvenating the Comités d'Organization from the Vichy years, which he renamed "industrial groups." Additionally, he proposed the creation of a National Economic Ministry as "a coordinating organ," whose primary purpose was to plan the national economy according to socialist guidelines (Kuisel, 1981: 179). Accordingly, labor spokesmen sat on a host of regulatory and advisory bodies comprising the system of wage, price, materials, credit, and other economic controls.

The Conservative Program

In the debates following WWII on how to regulate the French economy, René Courtin issued his report expressing the neo-liberal (pro-business) perspective, which was the main alternative to Philip's Socialist version. Courtin envisaged a "return to the market, economic freedom, and free trade" that prevailed during the Third Republic.[66] His vision for the French economy ultimately turned upon investment. " 'Still more than an abundance of natural resources and raw materials the wealth of a nation derives from the importance of its equipment.' The development of the stock of capital equipment depended on savings and investment. Do not look to the state, however, the neo-liberal economist admonished: 'the state has always been a wretched investor.' "[67] Neo-liberals sought to prevent the socialist agenda which would rely on intermediaries to implement their government-sponsored program.

To highlight the pro-market bias of Courtin's program, a socialist commentator remarked, "For our part we shall consider the report that was submitted to us for our evaluation appropriate only in case our country submits to an American economic and financial takeover and if we want to maintain liberalism to its utmost and direct the economy only by financial means."[68] But to determine which program would be adopted, we must consider these groups' political power.

Socialists and the Financial System

The Constituent Assembly (an interim legislature preceding the ratification of a new constitution and the election of the National Assembly in October 1946) was organized under the leadership of de Gaulle. A popular election was held in October 1945 confirming the leftward swing that had taken place in the electorate, and so the left overwhelmingly dominated the policymaking process. One of the first items on the agenda was the nationalization of banks.

Banks were nationalized first because credit was a critical element for reconstructing and managing the economy. The scope of nationalization was limited, however, because De Gaulle, who was sympathetic to big business, was able to postpone action for fifteen months, allowing the fervor of the liberation to subside. He then used his authority to circumscribe the nationalization of credit so that investment banking was excluded. After his resignation, the MRP (Popular Republican Movement) - the party most closely associated with him - succeeded in persuading his successor, Gouin, to confine nationalization to a shortened list of sectors and then fought, with some success, to limit the measures within these sectors (Kuisel: 208).

The banking act that was eventually passed on December 2nd 1945 completed the process begun by the Popular Front of eliminating private interests from the Bank of France, and nationalized the major commercial banks.[69] All representatives from the left and center voted for it (461 out of 494 representatives from mainland France voted for the law; 442 from the left and center, and 19 from the right; 33 on the right voted against).[70] The law structured French finance for the postwar period and "[gave] the government greater influence over the course of postwar economic development by placing the volume and allocation of credit firmly under its control."[71] The legislation established three agencies in charge of the financial system: the National Credit Council (CNC), the Bank of France, and the Control Commission. The CNC set the basic guidelines for credit policy, which were executed by the Bank of France. The CNC was headed by the Minister of Finance, as appointed by the prime minister, and comprised of representatives from the government and from various sectors of the economy. It had a broad range of responsibilities, including credit policy, establishing detailed regulations on bank interest rates and commissions, creating rules on entry or merger applications, imposing modifications on the financial and legal structure of banks, and levying sanctions on banks which violated its directives.

The Bank of France would enforce the policy directives of the CNC, and share policymaking powers through the governor of the Bank of France, who would be ex officio vice president of the CNC. The third agency, the Control Commission, would exercise technical supervision over banks' loan and investment operations. It would also supervise the banks to ensure compliance with all bank regulations, including regulations issued by the other two agencies. The Bank of France would be represented on the Control Commission by the governor of the Bank of France, who would also be president of the Control Commission.

The law nationalized the four largest deposit banks (or commercial banks: these held around half of all banks' assets and were the only banks with nationwide branch networks) and extended minor regulations over private investment banks. The largest insurance companies were also nationalized. The deposit banks and insurance companies came under control of quadripartite governing boards (consumers, employees, managers, and government). A National Insurance Council supervised the whole sector.[72]

The left-wing coalition in the Assembly overwhelmed political resistance to these measures by business interests who tried to obstruct or shape the legislation by exerting influence on the MRP. Business had lost its prewar national employers' federation, the sympathetic political parties of the Third Republic, and most of its friendly press. By mid-1946 the most significant structural reforms were enacted. The second Constituent Assembly that met in the summer and fall did not even discuss any further measures.

The postwar banking law was quite similar in terms of the formal control apparatus of 1941. However, the main difference was the sharply reduced banker representation on the control agencies, which was replaced with greater governmental power. Under the wartime legislation, the banks were able to use the prewar system of self-regulation to moderate interbank competition; the government only had veto power. In the postwar environment, the government could effect change despite bankers' opposition. Ultimately, the Socialist government succeeded in exerting control over the financial system in order to meet its larger objectives regarding the national economy.

Farmers

With the new provisional government, small farmers now enjoyed political influence equal to that of other groups in France; there was no longer a Senate to block their legislative initiatives. And as will be seen in the next section, the political institutions of the Fourth and Fifth Republics cemented their new political influence. Accordingly, we should see the financial system reflect this by developing more local, rural banking facilities, and by becoming more banking-oriented overall.

The Crédit Agricole remained intact at the end of the war, despite laws from 1940-43 permitting the state to use the Crédit Agricole's financing capabilities for wartime use. The ordinances of October 17, 1944 and October 20, 1945 sought to attract prisoners from during the war, or those deported and recently repatriated, to rural employ by offering favorable credit terms. The law of May 24, 1946 likewise targeted young people between the ages of 21 and 35, with subsidized loans. In 1946 there were 661 loans totaling 140 million Francs; by 1959 there were 168,000 loans totaling 914 billion Francs for these young rural workers.[73] Legislation immediately following the war was motivated largely because of food shortages.[74] While the extensive subsidies and favorable credit terms were necessary in this regard, the continuance of these generous benefits beyond the immediate postwar shortages illustrates that other political motives were at play.

The total value of loans made by the Caisses de Crédit Agricole grew from 171,467 in 1950 to 503,107 in 1955 to 993,708 in 1959.[75] Additionally, the balance of deposits increased tremendously. By 1959, the deposits of the Crédit Agricole represented about 11.2% of total deposits in the French banking system. Comparing this to its deposit base in the prewar era illustrates the enormous change.

Table 4.7: Composition of Deposits in France (in millions of contemporary francs)

	Total Deposits (1)	Crédit Agricole (2)	(2)/(1)
1913	18581	4	0.0002%
1920	64249	27	0.0004%
1930	156705	999	0.006%
1937	180105	1297	0.007%
1959			11.2%
1975	1246.5 (billion FF)	147.9 (billion FF)	11.9%

Source: Gueslin, André, 1992. "Bank and State in France from the 1880s to the 1930s: the impossible advance of the banks" in *Finance and Financiers in European History 1880-1960*, (ed.) Cassis. For 1975: Bayliss and Butt Philip 1980, 127. Original sources: for 1913 and 1937, Laufenburger, *Enquête*; for 1975, IBRO, and Journal Officiel.

Clearly, farmers were exercising considerable political influence over the structure of agricultural credit facilities, and the availability of finance. This will be discussed further in the next section on the Fourth and Fifth Republics.

4. 1946 – 1986, A Brief Sketch

Political Institutions of the Fourth and Fifth Republics

The political strength of labor after the war was institutionalized with the Constitution of the Fourth Republic, which was adopted in October 1946. Specified in its preamble were "the duty to work and the right to obtain employment" and the right to "health protection, material security, rest and leisure" and "the means to lead a decent existence" when unable to work. It assured everyone the right to "take part in collective bargaining to determine working conditions and in the management of enterprises."[76]

Much more powerful than the Council of the Republic (the Senate), important in the election of the Head of State, with full responsibility for laws and budgets, the Assembly (the lower House) in effect controlled the government. Basically, what the new Constitution proposed was an omnipotent Assembly, dominated by the political parties.[77] In terms of its partisan composition, there was a gradual shift away from the left after 1946, but they kept their majority status. According to the theory, we should expect the dominance of the left during the Fourth Republic to create and sustain a financial system heavily oriented toward banking.

The Fifth Republic was founded in 1958, with the more conservative de Gaulle as president, and a new constitution less oriented to labor's interests. According to its rules, the president would be popularly elected, serve a seven-year term, and could seek reelection. The National Assembly and the Senate (which together comprise the parliament) would enjoy coequal power. With regard to the balance of political power between the executive and legislature, Huber (1996) illustrates that the president is more influential with regard to foreign policy, and the parliament is more powerful when it comes to domestic economic policy.[78] Thus, to determine the structure of the national financial system, we must examine the balance of political forces in the parliament.

In the 1958 and 1962 elections, the Gaullist party (UDR: Union of Democrats for the Republic) appealed to voters from across the socioeconomic spectrum. Although it was located in the center-right, members from each part of society voted for the UDR: farmers, small business, employees of big firms, workers, and executives and employers. Among these groups, however, greatest support came from the employees of big firms, as well as executives and employers (Charlot 1971, 68). Toward the end of the 60s (in the

1967 and 1968 elections), the UDR's base of electoral support depended much more heavily on the votes of farmers, and small business (Berger, 1980; Charlot 1971, 68) as workers became increasingly frustrated with having to bear the costs of turning large firms into 'national champions' that could compete in the international arena.

These Gaullist policies mobilized the left. The oil crisis and stagflation led many voters in search of an alternative and helped the left gain popular support in the 70s. The right-wing parties were forced to appeal more to small business and farmers. Consequently, a political balance between the right and left ensued in the Assembly, and lasted throughout the decade, with the right holding a slim majority. In 1981, the Socialists came to power in greater force than ever before; this period will be discussed in detail in the next section.

Because de Gaulle favored big business at the expense of the left, one might expect market-oriented policies to be promoted. However, it is important to bear in mind that France's firms were still recovering from the war, and were not yet competitive in the international marketplace. For this reason, we should instead see subsidized lending via banks. However, this bank lending is different from the kind that the left would initiate since it would not be designed to boost employment. Increasing capital and trade flows during the 70s would also begin forcing the French government to promote its securities markets as pressure increased to maintain balance of payments equilibrium by reducing total spending (via subsidies).

With regard to small firms and farmers, because they were neglected during the 60s, we may likewise see a falloff in the extent of banking finance directed to them.

However, as the right-wing made a strong effort to cultivate their votes during the 1970s, banking services for farmers and small firms would be more likely to increase.

Big Firms

At the beginning of the Fourth Republic, French planning originated to deal with the problem of carefully distributing scarce resources as well as Marshall funds. Although planning was framed as apolitical, it was under the rule of parliament, and thus subject to political manipulation.[79] The First Plan was created and approved under an aura of nonpartisan agreement for managing the nation's scarce resources. The need for an appearance of consensus in the aftermath of the war created an illusory sense of unanimity among the parties approving the First Plan. Because the plan required the approval of the prime minister, who was appointed by the president and ratified by the National Assembly, and since so many of the mechanisms for executing the plan were under the control of the parliament, it quickly became a tool for achieving partisan objectives. Indeed, since the National Assembly approved the final draft of the plan, it could impose its political will on it. The evolution of the plans and their enforcement, or lack of enforcement, illustrate this.[80] With the consent of legislators, "The planning authorities have sought to influence the actions of the individual economic operators partly by using the "stick" (e.g., refusal of access to the capital market or to long and medium-term credit, or placing at the back of the queue for funds) and partly by distributing special "carrots" (direct and indirect subsidies, tax exemptions, and other favors)."[81]

The special deposit-taking institutions (including the postal savings banks, Crédit Agricole, the major national banks, etc.) would collect a substantial proportion of the economy's savings. Only a very small fraction of their deposits are lent directly to final users. These deposits would instead flow to the specialized lending institutions including the Crédit National, Caisse des Dépôts et Consignations and others (see Zysman, 1983: 118). These semipublic institutions would play a role in determining which bank loans would be eligible for the various government subsidies and privileges. Additionally, the rate of growth of the money supply has been set by a system of direct quotas on bank lending, known as the *encadrement du crédit*; certain industrial sectors have often been exempted from its lending limits. In essence, the additional step from saver to borrower allowed the government to stand between the savings and the investment institutions and thus to influence the allocation of funds (Zysman, 1983, 1977; Morin, 1974; Cohen et al. 1982).

The first three plans (1946-61) sought expansion at any cost. They channeled vast amounts of capital toward industrial sectors, rather than to individual firms, and offered it at subsidized rates thereby encouraging over-investment. From 1946 to the 1950s, the tight credit situation gave the government even greater control via its control over bank lending.

With the Treaty of Rome at the outset of the Fifth Republic, the planners believed that if the French economy were to compete effectively in the new European market, many of the isolationist, small, family firms would have to be abandoned in favor of larger and more competitive ones. This resolve was reinforced by the new President: "Nobody…insisted more than General de Gaulle on the need for France to be 'a great industrial power'" (Hoffmann, 1963: 77). Gaullists remained in power from 1958 to 1973, controlling parliament and the presidency, with this idea central to their political agenda. It is important to highlight that the beginning of the Fifth Republic marked a key turning point in the government's purpose for privileging banking finance: during the Fourth Republic, the left dominated government policymaking, and so banks could be used to fulfill more of labor's objectives; during the Gaullist years, labor was largely shunted aside in favor of business, and so banks were used to fulfill de Gaulle's aspirations for globally competitive enterprises.

Continuing the trend during the Fourth Republic, the government budget made direct provisions for a considerable proportion of investments in the late 50s and 60s; for example, in 1961 the total loans made by the Development Fund accounted for one-fifth of the total volume of investment in metropolitan France. Additionally, the government discouraged companies from issuing new capital on the stock market (Bauchet, 78-82).[82]

Policymakers began to use the Plan to forge an alliance with the largest enterprises in the fastest-growing sectors of the economy. Investment funds available in the 1960s were channeled to large, dynamic enterprises. The banks were directed to pursue policies that "favored the development of large enterprises rather than the accession of medium-sized enterprises to the level of the big ones".[83] By 1965 France had the highest rate of mergers in Western Europe.[84]

In 1965-66, reforms were instituted to make the banking system a more effective instrument of government policy in furthering the Fifth Economic Plan (1965-70), especially with regard to raising the level of investment for large firms. The commercial banks were assigned a key role. As the country's major financial intermediaries, they were strategically located to carry out the dual roles of collecting the public's savings and supplying business finance. To prepare the banks for a larger role in the financing of business expansion, the authorities took steps to improve their competitive position with respect to savings deposits. One important handicap had been the prohibition against deposit banks accepting deposits for more than two years (from the Banking Law of 1945). This prohibition was removed (along with restrictions on investment bank operations in demand deposits or deposits fixed for less than two years). Another handicap was the commercial banks' inability to offer rates as favorable as those the savings banks could offer which was also eliminated by authorizing the commercial banks to offer savings book accounts (*comptes sur livrets*) with identical limits and identical rates as the savings book accounts in the savings banks.

The abolition of restrictions on deposit maturities in commercial banks was also intended to increase the effectiveness of the commercial banks in their role as suppliers of funds. There were never any legal restrictions on commercial bank loan maturities, but because of the limitations on their deposit maturities, the banks have traditionally refrained from placing more than a small part of their funds in longer-term assets. As a result, the commercial banks have not performed as effectively as the Gaullists would like in financing investment, construction, or exports. By removing the restrictions on deposit maturities, the authorities hoped to increase the banks' flexibility and to encourage them to extend more medium and long-term credit (Alhadeff, 1968: 158-9). The dramatic rise in bank deposits from figure 4.1 during the late 1960s is the result of these new regulations.

Because financing directed by the government via banks restricted the financial freedom and flexibility for large firms, pressure grew to make securities markets a more effective fundraising tool. Several measures designed to promote an extension of the stock market were also passed in 1967. The Commission des Opérations en Bourse was created with the object of 'improving the ethical standards' of the stock market. These efforts were largely ineffective however. Obtaining cheap funds via subsidized bank loans was still better than the greater autonomy afforded by securities markets.

The Sixth Plan (1970-75) put renewed emphasis on the growth of heavy industry. It continued the goal of promoting large firms that could compete within the newly liberalized trading regime of the European Economic Community. Several factors, however, ultimately led the government to diminish its intervention in the financing of industry. First, it became clear that it was very difficult to judge the potential marketability of projects and to ensure their competitiveness, as with the Concorde and the Plan Calcul (Zysman, 1977). Indeed, as early as 1967 policy review commissions urged a return to the primacy of the market (Hayward, 1972). Second, French producers were finding it more difficult to remain competitive with cheaper foreign producers in a world of falling tariff barriers. This cost jobs at home and led to a losing battle for France's own domestic markets (Cohen, 1982). Third, the increase in oil prices in 1973-74 caused a global recession and imposed a 'tax' on French industry (Hall, 1986, 183-4). This was particularly burdensome for France, who relied heavily on foreign oil. Consequently, domestic inflation soared, many firms were forced out of business, and there was a significant and sustained rise in unemployment. What was once a surplus of 773 million dollars in 1973 in the French trade balance, turned into a 3.8 billion dollar deficit for 1974. France could not devalue the Franc to increase exports and improve the balance of payments since oil would become more expensive and nullify the benefits of higher exports. Finally, the medium and long-term debt of French enterprises was twice the size of its own capital holdings as of 1976, which led policymakers to worry that they would have to bail out much of French industry during a recession. These last two points were particularly problematic since France had to reduce its spending (in the form of subsidies) in order to retain equilibrium in its balance of payments, which became increasingly important as international trade and capital flows increased and made the exchange rate more important to France's economic health.

In 1973 the Socialists and Communists made considerable electoral gains, but not enough to win a majority of seats in the Assembly, which belonged to the center-right Union of Progressive Republicans; this coalition was divided between the Gaullist Party and Giscard's Independent Republicans. From 1974 to 1981, under President Giscard d'Estaing, the government stopped trying to manage the economy and turned towards a laissez-faire policy (Hall, 1986: 185-189).[85] Giscard's Minister of the Economy summed up the approach by saying: "I want to remove the administration from the day-to-day management of the economy."[86] Giscard sought to reform the system of securities markets and thus reduce the dependence of firms on lending by financial institutions. The program took off when the President replaced the Gaullist Chirac with Raymond Barre to be Prime Minister in August 1976 (Hall, 1986: 187).[87] Barre remarked, "my first objective, and I would even say my essential objective, is to maintain France's external balance and to assure the stability of the franc in the European Monetary System."[88] The massive balance of payments deficit had to be dealt with. The strategy was to make both the stock and bond markets more attractive to small savers and to provide wider access to the bond market.

The center-right retained a slight majority in the Assembly with the 1978 general election, but moved away from the Gaullists. Market-oriented policies were therefore further pursued. For example, the Loi Monory was passed in 1978, which provided tax credits for the first 5000 francs added to a stock portfolio and thereby raised the effective rate of return on such investments to over 30 percent, making stock purchases very attractive (Zysman, 129-30).

Rising levels of unemployment frightened policymakers into a retreat from strictly market-oriented policies, however, and thereby forced them to assist 'lame ducks' in both large and small businesses (Berger, 1981). It was necessary for the right-wing coalition to pursue these policies in order to retain their slim majority in government. Thus, the state continued to exert its muscle in banking through the use of subsidized and privileged credits. Their volume remained high. In 1979, for example, 25 percent of all loans to firms (nonfinancial and nonconstruction) were made at privileged rates; over 55 percent of all loans for exports were made at subsidized rates (Zysman, 1983: 122). Although the pressure for pro-market reforms increased, the labor vote constrained government's ability to make this happen. That is, cuts in spending had to come from other areas aside from subsidies to large firms.

During the postwar period, companies could avoid regulation of domestic securities markets by floating new issues abroad. Until the 1960s, however, government constrained this option by regulating access to foreign exchange, believing that the initial inflow of capital, which would beneficially affect the balance of payments, would be outweighed by future, potentially unpredictable debits on that account. Exchange controls were employed not only to ensure balance of payments equilibrium but also to ensure that priority activities received preferential access to foreign currencies. Although weakened considerably by the implementation of the European Economic Community policies, exchange controls remained in force until 1986 (Adams, 1989: 101-3).

In sum, France's large firms relied on subsidized financing from the government to restore and to bolster their competitive position in the European and global markets. Not until the mid to late 70s did the government make any effort to wean large firms off of subsidized lending, but this was a half-hearted attempt since rising unemployment and worsening economic conditions forced the right-leaning government to continue assisting large enterprises in order for the right-wing to retain their slim political majority in the Assembly.

Small Firms

Small firms enjoyed considerably greater power in the Fourth and Fifth Republics relative to their negligible influence in the Third. Accordingly, we should see more banking institutions and a larger proportion of bank lending catering to their financing needs.

In January 1948, the French Confederation of Small and Medium Enterprises (CGPME) issued a policy statement detailing the issues of greatest concern, which Ehrmann (1957) describes as the best description of this group's objectives.[89] In the section outlining the financing of small and medium enterprises, the author articulates the desire for increasing the availability of medium-term credit (to supplement short-term credit) from the popular banks[90] (during the postwar period, small firms relied primarily on loans from the popular banks, mutual credit banks, the Crédit Hôtelier, the Crédit National, and the regional development companies - Sociétés de Développement Régional). It also discusses how "the CGPME, in accord with the bankers' association, created a Commercial Office of Private Banks in order to facilitate the granting of credit, notably credit from the treasury, to small and medium enterprises who, for one reason or another, cannot obtain it from the nationalized banks."[91] This was largely due to system of allocating credit at subsidized rates to privileged large enterprises, especially during Gaullist period, which forced interest rates higher for firms outside the privileged circuit—small firms.[92] Nonetheless, there was still a dramatic improvement in the number of banks and the volume of lending directed to small firms following the war in comparison to the Third Republic.[93]

Toward the end of the 60s, the Gaullist governing coalition came to depend much more heavily on the votes of shopkeepers, farmers, and others sympathetic to the traditional sector (Berger, 1980). This ultimately led to the Seventh Plan (1975-81) giving priority to small, medium-sized, and artisanal enterprises rather than heavy industry: a 'programme d'action prioritaire' (Hall, 1986, 175).

Of note, the Industrial Development Institute (IDI) was set up in 1970 to provide equity capital for expanding small and medium-sized businesses (similar to a venture capital firm) and would operate closely with the Crédit National, which offers loans. In 1975, loans from lending institutions designed to cater to small and medium-sized business comprised 7.1% of total financing to the non-financial sector.[94] In accord with the right increasingly reliant on votes from small business and farmers during the 70s, we can see an increase in lending being directed through banking institutions serving these sectors:

Table 4.8: Loans granted for investment in France 1971-77
(billion Francs)

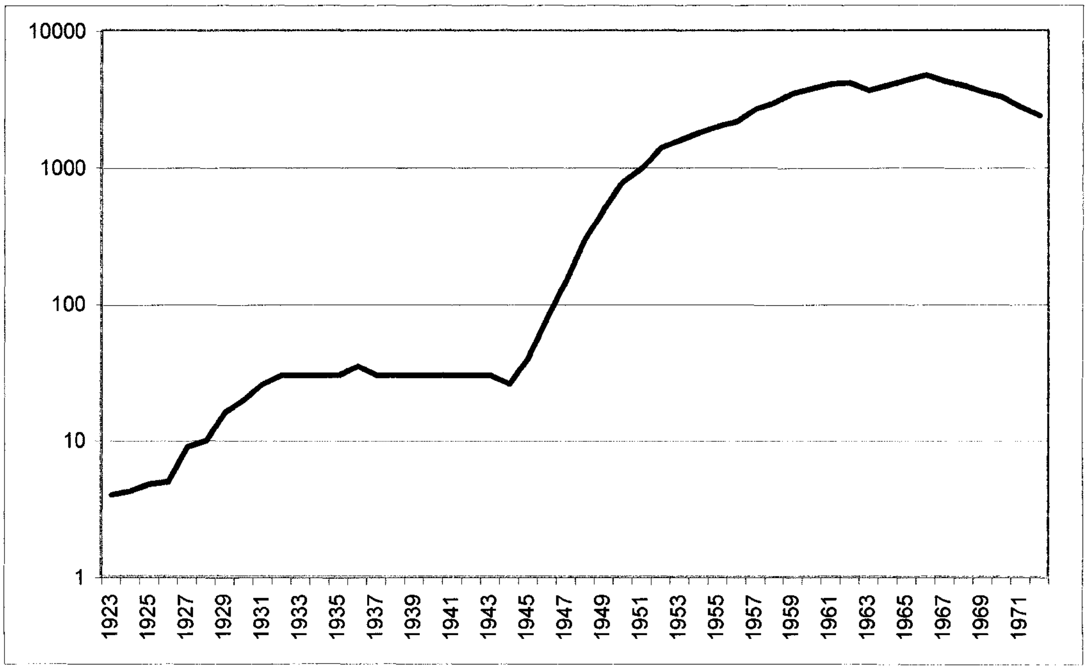
	Crédit National	Crédit Hôtelier	Crédit Agricole
1971	3.4	0.72	11.24
1972	3.4	1.1	15.84
1973	4.0	1.85	17.04
1974	4.8	2.07	21.7
1975	7.6	2.6	27.7
1976	4.7	3.76	28.4
1977	6.8	2.19	37.2

Source: Bayless and Butt Philip 1980. *Capital Markets and Industrial Investment in Germany and France*, p. 139.
Original Source: FDES, Rapport 1977-78, p. 31.

In sum, small firms were considerably better off than during the Third Republic, despite the disproportionate volume of financing directed to the largest enterprises. As we saw during the Popular Front, small firms exercised the greatest political power when the left-right political balance was very delicate. Because small firms could determine the success or failure of political parties in government, they benefited from an increasing volume of lending directed to them during the 70s.

Farmers

Greater political power for small farmers should likewise lead to higher levels of rural bank lending, and more local credit granting facilities. Between 1950 and 1963, Crédit Agricole medium and long-term loans rose from 630 million francs to 13, 000 million francs.[95] This expansion has continued as the bank has financed, with considerable government subsidy, the technical and infrastructural modernization of the countryside. The following figure illustrates the tremendous increase in government assistance to the Crédit Agricole during the postwar period in comparison to the pre-war era.



Source: adapted from Gueslin, André. 1984. Histoire des Crédit Agricoles, p. 322.

Figure 4.9: Value of Advances from the State to the Crédit Agricole (1923-1972)
in million of Francs (logarithmic scale)

Notice the steep incline following WWII and lasting until around 1950, which continues to rise at a slower pace until the early 60s. It is clear that the Gaullist government put the brakes on the amount of credit diverted to the agricultural sector. Loans continued to grow, despite the leveling off in government support; and because of its tremendous asset base, the Crédit Agricole was often considered the largest bank in the world.[96] In 1975, it made 12.8 percent of all loans made to the nonfinancial sector in France.[97] The Crédit Agricole has considerably increased its services to farmers in comparison with the prewar period, in addition to offering low rates of interest and increasing the availability of credit, corresponding to farmers' far greater political power (Carré, Dubois, and Malinvaud 1975, 337).

Socialists and International Capital Mobility

The dire economic straits of the 70s, culminating with the second oil shock of 1979 and the consequent inflation, austerity measures, and high unemployment levels, caused a backlash in the electorate, who thought that the Socialists might be better able to deal with these problems. In the 1981 general election the Socialist Party (PS) achieved an unprecedented share of seats in the National Assembly (37.8 percent of the vote and 59.5 percent of the seats), partly benefiting from Mitterand's overwhelming victory in the presidential election just prior to the general election. In 1981, the PS emerged as a temporarily center-left party which was able to capture votes on its left and its right; resembling UDR's victories from 1958 to 1968. The Socialist coalition was largely comprised of workers, but also attracted small business and many farmers. According to the argument, there should consequently be a sizeable move toward banking-oriented finance.

The keystone of the new Socialist government's economic agenda was the nationalization program completed in February 1982. Many of the ideas came from the Common Program, written in 1972, which was motivated by the dislocation and hardship that workers endured as a result of the Gaullist initiative to pursue industrial growth to the detriment of the social welfare of employees and small business. The Common Program proposed nationalization of the entire financial and banking sector and nine industrial groups, as well as the acquisition of shares in many other major concerns in strategic sectors of the economy.[98] As a result of the oil shocks, business bankruptcies, and rising unemployment, workers again sought help from the state in the early 80s. The left saw nationalization as a means toward various ends: the implementation of workers' control, the elimination of private profit, the strengthening of unions, employment stability, and even the rescue of France's industrial base which appealed to the business community. Nationalizations ensured that several sectors of French business continued to invest heavily despite the world recession.

Although the largest French banks were already under state control in 1982, the Government nationalized 36 smaller banks, two investment banks, Suez and Paribas, and the remaining minority of private shares in the Crédit Lyonnais, Banque Nationale de Paris, and Société Générale. It also acquired 100 percent of the shares in six industrial conglomerates.[99] State debt in the two major steel firms, Sacilor and Usinor, was converted into a majority shareholding, and the government acquired 51 percent of the shares of two arms and aeronautical manufacturers, Dassault-Greguet and Matra, as well as control over the computer firm CII-Honeywell-Bull, and the pharmaceutical house, Roussel-Uclaf. The state subsequently owned 13 of the 20 largest firms in France and a controlling share in many other French companies. State holdings accounted for 24 percent of the employees, 32 percent of the sales, 30 percent of the exports, and 60 percent of the annual investment in the industrial and energy sectors of the French economy. The government was also now in direct control of 96% of all deposits.

Funds for investment were made available to each enterprise through the state-controlled banks in return for signing a 3-5 year 'planning contract' with the Ministry of

Industry. Almost half of these funds went to the steel and chemical sectors alone. The nationalized banks were subsequently instructed to lend 6 bF to the nationalized industries, purchase 7 bF in state debt during 1983, and maintain their industrial lending rates at 14 percent (Hall, 1986: 205-6). Small and medium-sized enterprises were also expected to benefit from these loans. Ultimately, the state used its control of finance to support businesses during the recession to avoid layoffs. In contrast to the Gaullist period, Socialists used its control of finance primarily to improve the welfare of workers.

The residual consequences of the second oil shock, plus the deep international recession of 1982 ultimately undermined the government's capacity to pursue its goals. Huge losses in 1981-82 by the newly nationalized firms required extra funding as well as compensation for shareholders. Consequently, Socialists advocated a new austerity plan in 1982-83 and a new emphasis on managerial autonomy and profitability in both public and private sectors.

In 1983 the Socialists passed several laws to enable the nationalized enterprises to dilute state ownership through the sale of nonvoting shares. In late 1983, many firms had already started down the road to privatization and began to issue bonds (*titres participatifs*), and to float nonvoting shares (*certificats d'investissement*), in order to raise capital that the government was no longer willing or able to provide at the desired level. Indeed, many firms were already turning to foreign markets for some of their financing needs (Louriaux, 1991). Many nationalized enterprises also started to sell off their subsidiaries.

The first few Mitterand years revealed the extent to which even a Socialist regime with a firm mandate is constrained by the international economy. As the Government ran up against economic constraints that derived from its insertion into world markets (particularly in the form of higher interest rates on its bonds), it was forced to adapt its strategy to the operation of market forces (Hall, 1986: 225). To compete with the US for international funds, France had to reduce its debt and deregulate its securities markets. The Minister of Finance, Bérégovoy, argued that deregulation would reduce interest rates charged to industry, and subsequent analysis confirms that it did by about 2%.[100]

In 1984, five different kinds of new reforms were introduced.[101] First, there was the authorization of new financial instruments, such as interest rate and currency hedging instruments (e.g., swaps). More importantly, however, was the opening of the Paris financial futures market (the Marché à Terme des Instruments Financiers, or MATIF). Second, commissions on large transactions became negotiable in 1985, favoring the larger investment institutions. This reduced the cost of transacting in the capital markets for these large clients. The third set of reforms involved extending the powers of the main regulatory body, the Commission des Opérations de Bourse, over the securities markets. Fourth, public sector firms were privatized, including the Saint-Gobain conglomerate and the Banque Paribas. The final set of reforms involved an end to the agents de change (brokers) monopoly with the January 22, 1988 law.

Conclusions

During each period of French history, interest groups played a critical, if not decisive, role in determining the structure of the French financial system. In the Third Republic, big firms and the rural elite ruled, while labor, small firms and small farmers lacked political power. Because there were sufficient savings to satisfy the financing needs of big firms at this time, and large, capital-intensive enterprises held a comparative advantage in the international economy, the state did not need to use banks to allocate investment, and so these firms relied heavily on securities markets as France industrialized. The large rural elite also benefited from increasing agricultural banking services which catered to them but not to smaller farmers. Not until the Popular Front did labor, small firms and small farmers achieve sufficient political power to effect financial reform with the Bank of France Law. However, these changes were not put into practice since the Popular Front coalition quickly disintegrated.

The need to control the allocation of scarce funds and to direct financing to priority industries involved in the war effort transformed French finance from a market-oriented system to one centered around banks. After the war, the left dominated government policymaking and consequently nationalized the major commercial banks to pursue reindustrialization that benefited labor. This new republic also favored farmers and heavy industry; many large firms and small firms lacked political influence.

In contrast to the Fourth Republic's labor-oriented policies, de Gaulle's right-wing government used the nationalized banking system to direct finance toward large firms in an effort to develop 'national champions' that could initially compete in the European marketplace, and later, in the latter half of the 60s, to encourage the development of enterprises that would be competitive in the global arena. But promoting industrial growth came at the cost of reduced wages and social benefits for workers, eventually leading to the May 1968 strike. To deal with the loss of workers who had formerly supported de Gaulle, the UDR (and the right-wing) started appealing to small firms and farmers in the latter half of the 60s. In the 70s, the right held a slim majority and bolstered financing directed to small firms and farmers to retain their loyalty at the ballot box.

The oil crises of 1973 and 1979, along with stagflation and mounting public debt forced the government to encourage large firms to seek private sources of finance, particularly from foreign and domestic capital markets. Mounting unemployment and high inflation created a backlash to the right-wing initiative to privatize and rationalize industry. The Socialists were swept into office in 1981, drawing primarily on the votes of workers, but also small firms, many farmers, and big business that couldn't compete in a liberalized marketplace (e.g., steel). Mitterand and the PS nationalized many firms and banks, and provided them with financing despite the recession in order to prevent layoffs. This became very costly since France was ringing up large debts which raised its cost of borrowing in international markets. Ultimately, the Socialists were forced to privatize many of these firms and adopt neoliberal, market-oriented policies in order to lower French debt and to keep the financing business of large French firms at home. Beginning in 1983, and continuing throughout the rest of the decade, the Socialists passed legislation bolstering the domestic securities markets.

It is important to conclude with the observation that new political institutions in the postwar era gave greater political power to small farmers and small business, which translated into a greater reliance on banking institutions than would have otherwise been the case. For example, bank loans to farmers relative to total big business loans was less than 3% prior to the Great Depression; small business loans relative to big business loans was less than 1% before the 1930s. In 1975, lending to farmers constituted around 12.8% of total loans to the nonfinancial sector (and an even higher percentage relative to loans to big business), and lending to small business amounted to 7.1% of total nonfinancial sector loans (it would also be a higher percentage relative to loans to big business).

More important than farmers and small business in moving the country toward banking was the rise of left-wing political power after WWII. Because of Socialist legislation following the war, the four major commercial banks were nationalized, and 50% of all deposits were placed under government control. Later, in 1981, 36 more banks and the two major investment banks were nationalized, placing 96% of all deposits under the direct control of the government. As figure 4.2 illustrates, there was a dramatic increase in the reliance on banks.

But the most important actor influencing the bank-market orientation of the financial system has been the large enterprises. Because of their political power, France relied on capital markets during the Third Republic. After WWII, the largest firms benefited from subsidized loans since they were uncompetitive in their main foreign markets. Once the government could no longer afford to offer these, large firms' financing needs forced France to liberalize its own domestic capital markets in the late 70s and 80s.

[1] Gueslin (1992) offers ample evidence that relative to capital markets, banks overall were not heavily relied upon in the pre–WORLD WAR II era.
[2] Bank financing also experienced a change from a reliance on private banking in the 1920s to public banking in the 1930s (Gueslin, 1992: 85).
[3] Data are from the INSEE's Annuaire Statistique de la France, Résumé Rétrospectif 1966.
[4] See Huber, 1996, *Rationalizing Parliament.*
[5] See the American literature on congress-executive (bureaucracy) delegation, for example. Key theoretical pieces on delegation include Kiewiet and McCubbins (1991), McCubbins and Schwartz (1987), Lupia and McCubbins (1994a & 1994b), McCubbins and Page (1987), Ferejohn (1987), McNollgast (1987, 1989, 1990), Weingast and Moran (1983), Ferejohn and Shipan (1989), Calvert, Moran & Weingast (1987), and Calvert, McCubbins & Weingast (1989).
[6] The Chamber of Deputies was directly elected by universal manhood suffrage and in 1871 this operated under a system of departmental proportional representation. This gave way in 1875 to a system of single-member constituencies.
[7] Gildea, 1996.
[8] The party label is useful when there are electoral incentives to using it, and these accrue when the party label acts as a useful heuristic for voters (Cox and McCubbins, 1995). That is, if a legislator's reelection chances are enhanced by following party advocated actions, then a lawmaker is more likely to vote along party lines. In the French Third Republic, there were few incentives for Senators to need the party label to enhance their reelection chances since they were indirectly elected by local leaders, and therefore the party label would not serve as a useful heuristic to these voters since they were probably much more knowledgeable about the Senator.
[9] During the Third Republic, cabinet turnovers were very common. Between the time of the consolidation of the power of the French Republicans in 1879 and the fall of the Third Republic in 1940, France was governed by a succession of 94 Cabinets, with an average life of 8 months. During the same period, there were 44 prime ministers, occupying the position for an average of 16 months. In Great Britain, during the period between 1880 and 1940, there were only 21 Cabinets, with an average life of almost 3 years, and only 11 persons served as prime minister, occupying the position for an average of more than 5 years. Of the 94 French Cabinets of the period, only 8 remained in office for two years or more (none after 1928) and only 10 remained in office between one and two years (Pierce, 1983: 21). While there was a great deal of continuity of personnel and of policy throughout the numerous cabinets, the considerable instability of ministries further contributed to the dominance of parliamentary control.

The government (executive) did not control the parliamentary timetable, and government bills were given limited priority. The central feature of the legislative process was the system of committees. Every bill passed through a committee before coming to general debate, and might be indefinitely delayed or extensively amended. In fact, this was a common legislative procedure in the Senate to delay legislation sponsored by the Chamber. At the next stage, it was the committee's version of the bill rather than the government's original proposal that was debated. In any case, by the time a bill emerged from committee the government had frequently changed, and bills could be carried over from one legislature to another. Legislation was therefore a process largely independent of changes of government, and was in the hands of the parliament, not controlled by the executive.

[10] Kuisel, p. 178. Also, see Vinen (1991) *The Politics of French Business, 1936-1945*, pp. 45-52, for a discussion on how small business was excluded from political power to the benefit of big business during the Third Republic.

[11] For example, Carré, Malinvaud and Dubois, 1975, p. 518, approximate agriculture and industry to contribute the following proportional amounts to the total national production.

	Agriculture (%)	Industry (%)
1896	26.5	38.9
1913	21.5	40.6
1929	18.8	41
1938	20.9	37.2

[12] Gueslin's book, *Les Origines du Crédit Agricole (1840-1914)*, offers a very thorough account of the formation of the Crédit Agricole.

[13] According to Karl Born, "Napoléon was returning a favour to his supporters among the rural population" (1983, p. 104).

[14] A related issue which delayed the passage of the law for about four years was whether to create popular banks which would cater to small businesses and individuals in addition to farmers, or to create a credit facility which exclusively served agricultural financing needs. Because many politicians opposed aiding labor, the latter option was finally passed with the 1894 law (Gueslin, 1978: 142).

[15] There was considerable variation in the amount of money allocated to different departments, which was not in proportion to the agricultural population. Gueslin (1978: 320) suggests that some of the factors affecting the amount of money distributed to each department include such things as the dominant agricultural speculation at the time, the size of the farmer, and the politics of the agricultural office (local/regional).

[16] Total loans grew from 1.9 million F in 1900 to over 104 million F in 1913.

[17] According to the March 1911 census, there were 5,271,000 active male agriculturalists. At the end of 1910, the number of members of agricultural caisses was 151,621.

[18] See Gueslin (1984) *Histoire des Crédits Agricoles.*

[19] Boussard, Les Agriculteurs de la republique; Ministere de l'agriculture, Cent ans de Ministere de l'agriculture; Sheingate, The Rise of the Agricultural Welfare State.

[20] Henry and Regulier: 48-9.

1928	45%	1932	65.74%
1929	53.83%	1933	40.84%
1930	55.17%	1934	51.82%
1931	59.21%	1935	66.96%

[21] A. Raffalovich, Le Marché Financier, 1911-1912, p. 327.

[22] Freedeman, p.81.

[23] For more information on these mutual banks, see Sylvie Boudoulec, "Les Banques populaires des origins à la loi de 1917," *Revue de l'économie sociale*, V (1985), pp. 17-24.

[24] That is, until the 1967 law under de Gaulle's right-wing government

[25] The nominal capital of new joint-stock companies and partnerships for the Paris area mirrored the rise and fall of the boom: Freedeman, 1993: 28.

1878	335MF	1882	1276MF
1879	930MF	1883	545MF
1880	1285MF	1884	379MF
1881	2632MF		

[26] Quoted by Freedeman, 1993: 38. Originally from *Examen critique du project de loi sure les sociétés par actions* (Paris, 1886).

[27] Duchemin, *Organisation syndicale patronale en France*, Paris, 1940.

[28] Minimum Program of the CGT.

[29] Lorwin, 1954: 52-53.

[30] See Warwick, Paul (1977) *The French Popular Front*, for a thorough account of the legislative record of the weakened Popular Front.

[31] F. Goguel, Géographie des elections françaises sous la Troisième et Quatrième République, Paris, 1970, pp. 92-97.

[32] Cleary, Mark. 1989. *Peasants, Politicians, and Producers*, p. 85.

[33] The Communists' program called for higher farm prices and the defense of working peasants' property. The Socialists' platform strongly resembled that of the Communists, except for putting more emphasis on the interrelationship between the farm crisis and the general crisis. The Radicals, after asserting, "Le parti agraire, c'est nous," proposed similar remedies, but added references to tariff protection and to the need for organizing the profession. The right-wing groups were more inclined to rate the farm crisis as the nation's outstanding problem, and hinted at a corporatist solution by their references to *la classe paysanne*. From left to right, every party put higher farm prices at the top of its list of goals. Dupeux, *Le Front Populaire*, pp. 103-17.

[34] Pierre Cot, 1932, "La Rajeunissement des parties," in Henry de Jouvenel, ed., La Rajeunissement de la politique. Paris: Editions Correa, 932. pp. 155-73. Also see Peter Larmour, 1964, *The French Radical Party in the 1930's*. Stanford: Stanford University Press, p. 19.

[35] See Larmour, 1964, p. 213.

[36] For example, Archimbaud, a 'thorough-going left-winger,' asked for an end to the strikes and to the attacks on the rights of property which were leading to a strong anti-Communist sentiment among the Radicals. Larmour, 1964, p. 215.

[37] See Kuisel (1981), p. 116.

[38] On the importance of the middle class, see Charles Vincent (1938), *The Popular Front in France*, London: Independent Labour Party.

[39] See, for example, Vinen (1991) and Ehrmann (1957).

[40] See Ehrmann (1957).

[41] See Ehrmann (1957), p. 40.

[42] See Revue Générale des Industries Radio-Eléctriques, 1936, as quoted in *La Tribune des Fonctionnaires*, 28 November 1936. Also see Ehrmann (1957) and Vinen (1991) for additional details on the relationship between the CGPF and small and medium-sized enterprises.

[43] See Wright, 1964, p. 66.
[44] Debates surrounding these issues are discussed in Michel Margairaz's *Les Propositions de Politique Economique Financiere et Monétaire de la SFIO, de 1934 à 1936: La Reflation*, Université de Paris, 1972.
[45] Kuisel, p. 108.
[46] De Man described his postion in *Au delà du Marxisme* (Brussels, 1927) and *Socialisme constructif* (1932). Peter Dodge also wrote a biography, *Beyond Marxism: The Faith and Works of Hendrik de Man* (The Hague, 1966).
[47] Quote from J. Itard, in Margairaz, p. 249.
[48] E. LeFranc and J. Itard, "La classe ouvrière a un plan" in *Le Populaire*, 13 mars, 1935. Emilie Lefranc was secretary of the Centre Confédéral d'Education Ouvrière (Institut Supérieur Ouvrier et Collèges du Travail) and professor of French language and literature. Jean Itard was a professor of mathematics at the l'Institut Supérieur Ouvrier, a militant socialist and union leader.
[49] Kuisel, p. 110.
[50] Kuisel, p. 110.
[51] Dupeux, 1959, provides a copy of the original Program, pp. 180-83.
[52] The Program colorfully entitled the main section seeking reforms of the financial system, "Against the pillage of savings for a better organization of credit."[52]
[53] For reform of the Bank of France, see Jean Bouvier, Un Siècle de banque française (1973), pp. 158-9, 178-90; Lucille Dromer, "Les Limites de la réforme de la Banque de France, juillet 1936," Recherches et travaux, Institut d'Histoire Economique et Sociale de l'Université de Paris-I, no. 7 (Dec. 1978), pp. 52-70; Achille Dauphin-Meunier, La Banque de France (1936). Examples of the left's campaign against the bank are Albert Aymé-Martin, Nos Grands Financiers contre la nation (1931); Francis Delaisi, La Banque de France aux mains des 200 familles (1936); Augustin Hamon, Les Maîtres de la France, 3 vols. (1936-8).
[54] Bouvier, p. 185.
[55] Rapport Brunet: J.O. Documents parlementaires, Chambre des deputes 1936, Annexe no. 664, pp. 1290-1306.
[56] Dauphin-Meunier, La Banque de France, p. 199.
[57] It would be preferable to have information on the constituency of each deputy (e.g., proportion of labor, farmers, small firms, large firms) to run statistical tests to check whether their votes conform to my theory's expectations. Given the lack of information, I must use the simpler left-right dimension for assessing their voting behavior. Of course, however, side payments and other forms of strategic voting would likely influence their voting behavior.
[58] Kuisel, ibid. p. 120.
[59] See, for example, Hoover Institution, *France during the Occupation*, 1:148.
[60] Alhadeff (1968: 136-8) offers more detail on the specific provisions of the legislation. Also see Beckhart (1954: 229-33) and Wilson (1957: 282-84).
[61] André Philip was a professor of economics who had investigated American production techniques during the interwar years and published a study of de Man in 1928. He was an advocate for Socialist reform from the 1930s on.

[62] Kuisel, 1981: 173.
[63] Philip, "Réformes économiques," p. 4.
[64] Ibid., pp. 6-7.
[65] André Philip's report was published by the Parti Socialiste, Pour la Rénovation de la République, and entitled *Les Reformes de Structure*.
[66] Kuisel (1981), p. 171.
[67] Kuisel, 172, and Courtin, *Rapport sur la politique économique d'après guerre* (Algiers, 1944), p. 41.
[68] Commissariat à l'Intérior, "Critique de rapport sur la politique économique d'après guerre présenté par le Comité National d'Etudes de la résistance," June 1944 (AN F[1a] 3791).
[69] For information on the formulation and effect of this banking legislation, see Alhadeff's six chapters on French banking in *Competition and Controls in Banking* (1968), Wilson's *French Banking Structure and Credit Policy* (1957), the France chapter by Henry Germain-Martin in Beckhart's *Banking Systems* (1954) and Dupont's *Les Contrôle des Banques et la Direction du Crédit en France* (1952).
[70] A key law passed early on with the new government on February 22 1945 (even before the Banking Law) was a reform to realize the old trade union demand for a voice in management by the establishment of labor-management planning committees. These works committees would become obligatory in all firms with 100 or more workers, which included 7000 to 8000 firms employing about 2.5 million workers (out of a total of 1,800,000 firms and 12.5 million wage earners; agricultural workers are not included; see Pickles, 1953, French Politics, 54). Made up of elected representatives of employees, presided over by the employer or plant manager, the committees were given control of plant social welfare work and consultative powers in production and economic decisions. The legislation fell short of the left-wing representatives' hopes, who wanted works committees to be compulsory in all establishments employing fifty workers or more (which was achieved with the act of May 16 1946, adding 750,000 more workers), and who would share in the running of firms instead of merely being consulted about management. With this act, workers had the right to be informed of the amount of profit made and could make suggestions regarding the use of these profits (special provisions applied to limited liability companies. Here the Committee was empowered to inspect the books before the annual general meeting and to call in an accountant to help members to understand the points at issue. This was resented by right-wing members of the Assembly and by employers. The act of May 16 1946 also provided for the inclusion of delegates from Works Committees on the boards in an advisory capacity. For further discussion on the usefulness and powers of Works Committees, see ILO, *Labour Management Cooperation in France*, 1950, pp. 186-8). A later act imposed an obligation on the employers to consult (not merely to inform) them before putting into force decisions regarding the general running of the firm.

In April 1946 another piece of legislation created the délégués de personnel in all firms with eleven or more employees. These were designed to present individual claims to management through works councils which sought to eliminate conflict between workers and management inside the firm(Howell, 1992, 49).

[71] Alhadeff, 1968: 138.
[72] Alhadeff, 1968.
[73] Henry and Regulier: 74.
[74] Kuisel, 1981: 187.
[75] Henry and Regulier.
[76] See Gordon Wright, *The Reshaping of French Democracy* (New York, 1948) and Lorwin, *The French Labor Movement*: 104-5.
[77] See Rioux, 1987. For parliamentary control of the executive and ministries, see Petry, in Laver and Shepsle, 1994: 136.
[78] With the new constitution, the president has the power to dissolve parliament. In fact, if the president opposes a policy favored by the majority in the National Assembly, dissolution is a credible threat if public opinion is on the president's side. In 1981 and 1988, for example, a conservative majority controlled the National Assembly when the Socialist François Mitterand was elected President. Immediately following his victories, he dissolved the National Assembly and returned a huge Socialist majority in 1981. In 1988, the outcome was also a success, although a more modest one because the Socialists were forced to form a minority government. However, if an election would not return a majority to parliament that is more sympathetic to the president's policies, then dissolution threats do not enable the president to influence policy outcomes.

Additionally, the president names the prime minister but cannot legally require the prime minister to step down. Since any prime minister must receive the confidence of parliament, the president must appoint a prime minister who commands the support of a majority in parliament. For example, in 1986 and 1993, Socialist President Mitterand was forced to name a conservative prime minister because right-wing parties had won legislative majorities in elections to the National Assembly. "The power to name the prime minister, while potentially useful in resolving internal party struggles, permits little influence over policy outcomes when a majority in parliament does not support the president" (Huber, 1996: 25-26).

The parliamentary bias of France's political institutions was clearly illustrated during the 1986-8 period of cohabitation. Two conservative parties, the Gaullists and the UDF, gained a narrow legislative victory in 1986. Consequently, Socialist President François Mitterand was forced to name a Gaullist prime minister, Jacques Chirac. Except for some issues concerning foreign relations and defense (on which Mitterand and the conservatives largely agreed), Mitterand stood on the legislative sidelines while Chirac functioned as France's political executive. The conservative coalition implemented important policy reforms opposed by Mitterand, such as the denationalization of many French industries, the reinstitution of a two-round, single-member district electoral law, and changes in labor law (Huber, 1996: 28). Thus, parliament dominates domestic economic policymaking, while the president is more influential with regard to foreign policy. And in the parliament, the lower and upper houses are equally powerful.
[79] On the objectives of French planning, see Baum, 1958: 4, 22; Bauchet, 109, 113-18; Kuisel, 1981: 228; and Hall, 1986: 144 for more detail.

[80] For the clear political influence on the plans, see Hall, 1986. For details on executing the plans, see Baum, 1958: 24; Bauchet, 76; Lutz, 1965: 37, 59, 61; Alhadeff, 1968; Kuisel, 1981: 228; Hall, 1986: 144, 156; and Zysman, 1983: 111-138.
[81] Lutz (1965, 59). According to Zysman (1983: 129-30), the government influences fund allocation in three ways: through intermediaries such as the Crédit National; by preferential terms of refinancing and by subsidies accorded to loans through commercial banks; and through government influenced allocation of loans in the nonprivileged market (the market in which government does not selectively manipulate access or prices, is not a truly free market). During the first twenty years following the war, administrative discretion in the allocation of loans in the nonprivileged market was tied to a system of rediscounting bank loans. It then changed to ceilings on the amounts a bank can loan, regardless of its total deposits or reserves, as the basic device for controlling the market. When a bank pushes beyond allotted limits, the price at which it can refinance the loans by borrowing funds from the central bank is prohibitive and additional lending is thus constricted. Exceptions to these credit ceilings are granted for favored loans.
[82] Between 1947 and 1955 government exercised tight control over issues of new securities. The budget act of 1947 authorized the treasury to veto almost any new offering of bonds or equities. In exercising this veto the treasury considered both the timing of the flotation and the use of the funds. According to François Bloch-Lainé and Pierre de Vogüé, "this procedure permitted an allocation of funds to those most likely to use them in the public interest" (see Bloch-Lainé and Vogüé, Le Trésor Public et le Mouvement Général des Fonds, p. 185). In other words, the treasury used its power with the intention of influencing the composition of investment (Adams, 1989: 101).
[83] Warnecke and Suleiman, 1975: 38; Friedberg, 1973, 1974; Gremion, 1974; Priouret, 1968. Also see Hall, 1986: 168-71 for more on this close alliance with big business. Politicians justified their support of big business by appealing to the importance of technical expertise governing the economy rather than political priorities (Hall, 1986: 177-79).
[84] Two noteworthy laws affecting firms' corporate governance were passed in 1966 and 1967. The first was a law offering the possibility of organizing the société anonyme on the German model, i.e., with a directorate and a supervisory board instead of the conseil d'administration (board of directors) of 1867. The second innovation was the institution in 1967 of 'economic groupings' designed to promote the creation of bodies common to several companies (Caron, 1979: 281). This second law essentially permitted the concentration of large firms in accordance with de Gaulle's vision of having national enterprises competing in the international marketplace. Indeed, Caron remarks that, "the last years of the 1960s were dominated by the more rapid growth of large enterprises. There is also an acceleration in the tendency toward mergers..."(Caron, 1979: 292).
[85] Probably internationally competitive large firms preferred Giscard while uncompetitive large firms preferred Gaullists.
[86] Hall, 1986: 187; originally from *London Times*, 10 November 1978.
[87] Chirac was a necessary original choice in 1974 because of the more Gaullist-oriented Assembly.

[88] Le Nouvel Economiste, 16 June 1979: 31. For more on Giscard and Barre's economic program and how it contrasted with the Gaullist program, see Lauber, 1983: 93-97 and 103; Spivey, 1982: 45 and 59; Wright, 1984: 143, 149, and 152; and Penniman, 1980: 97-99, and 213.

[89] The organization of the CGPME and its principles are described in the article, "Confédération Générale des Petites et Moyennes Entreprises," *France Documents*, Nouvelle Série, No. 15, January 1948, pp. 1-19.

[90] Ibid., p. 9.

[91] Ibid., p. 9.

[92] See Carré, Dubois, Malinvaud 1975, 336-7, and Spivey 1982, 70.

[93] See Henry Germain-Martin in Beckhart, 1954, *Banking Systems*: 259-261.

[94] Source: Dimitri Vittas, ed., Banking Systems Abroad (London: Inter-Bank Research Organisation, 1978), p. 129. Institutions added together include popular banks, mutual credit banks, Crédit National, cooperative credit institutions, and regional development corporations.

[95] INSEE 1986.

[96] See, for example, N. Makuch, J. Peyne, and P. Prunet, *Le Crédit Agricole* (Paris: Berger, Levrault, 1978); and Jean Claude Gaudibert, *Le dernier empire français* (Paris: Seghers, 1977).

[97] See Dimitri Vittas, ed., *Banking Systems Abroad* (London: Inter-Bank Research Organisation, 1978), p. 129. Also in Zysman (1983: 120).

[98] *Programme Commun de gouvernement du Parti Communiste et du Parti Socialiste* (Paris: Editions Sociales, 1972), p. 113.

[99] These include the Compagnie Générale d'Electricité (CGE), the Compagnie Générale de Constructions Téléphoniques (CGCT) and Thompson-Brandt in electronics and telecommunications, Rhone-Poulenc in textiles and chemicals, Péchiney-Ugine-Kuhlman (PUK) in aluminum and chemicals, and St Gobain-Pont-à-Mousson in glass, paper and metals.

[100] See his preface to the Livre blanc sur la réforme du financement de l'économie, 1986). See Cerny, 'The "Little Big Bang" in Paris.'

[101] See Cerny, 1989, in Godt (ed.) for more detail. Also see Cerny, 'The "Little Big Bang" in Paris.'

Chapter 5

Japan

Why did Japan switch from a heavy reliance on securities markets during the prewar era (1889 – 1937), to depending primarily on banking finance after the second world war? Unlike France, and most European countries, the left has been very weak in the postwar period, making Japan's reliance on banks an intriguing puzzle and useful contrast.

During the Meiji Constitution era (1889-1937), big business and wealthy landowners wielded the greatest political power. And, as in France, Japan's securities markets were dominant. With the onset of the war against China in 1937, Japan started to privilege banks in order to direct funds to the military-industrial complex; WWII deepened the close relationships developing between large industrial firms and banks. After the war, capital was scarce, and the government intervened to allocate finance to essential industries, cementing the bank-firm relationships established during the war. Once the credit shortage subsided, the government continued to direct credit at subsidized rates to favored infant industries (relative to American companies) via MITI. Because the new political institutions substantially increased the political power of farmers and small business, there was a dramatic increase in the banking facilities catering to these groups. Also, big business continued to be political powerful, and politicians likewise catered to this groups' financing demands. Labor was politically weak, making it easier for large firms to get the kind of financing that they desired. As a result of the oil crises in the 70s, and the ensuing stagflation and deficit problems, the government could not afford to continue its levels of subsidized lending. This forced the largest firms to seek financing from the Euromarkets, and this in turn caused the Japanese government to draw them back by bolstering its domestic securities markets.

This chapter is broken into two sections. In the first section, I summarize the historical trends of the dependent and key independent variables from the late nineteenth century up to 1990. This will illustrate whether there are any clear correlations that support the hypotheses from chapter two. Additionally, it aids in identifying moments in time when the variables change considerably, and which therefore deserve to be examined in detail. In the second section, I offer a detailed analysis of such a period in Japanese history: 1937-1952. To properly frame this discussion, I briefly discuss the era preceding this transition period and assess whether and how it conforms to my theory. I also offer a short analysis of the postwar period, and discuss why Japan's reliance on banks and eventual market-enhancing policies match the expectations of my core argument.

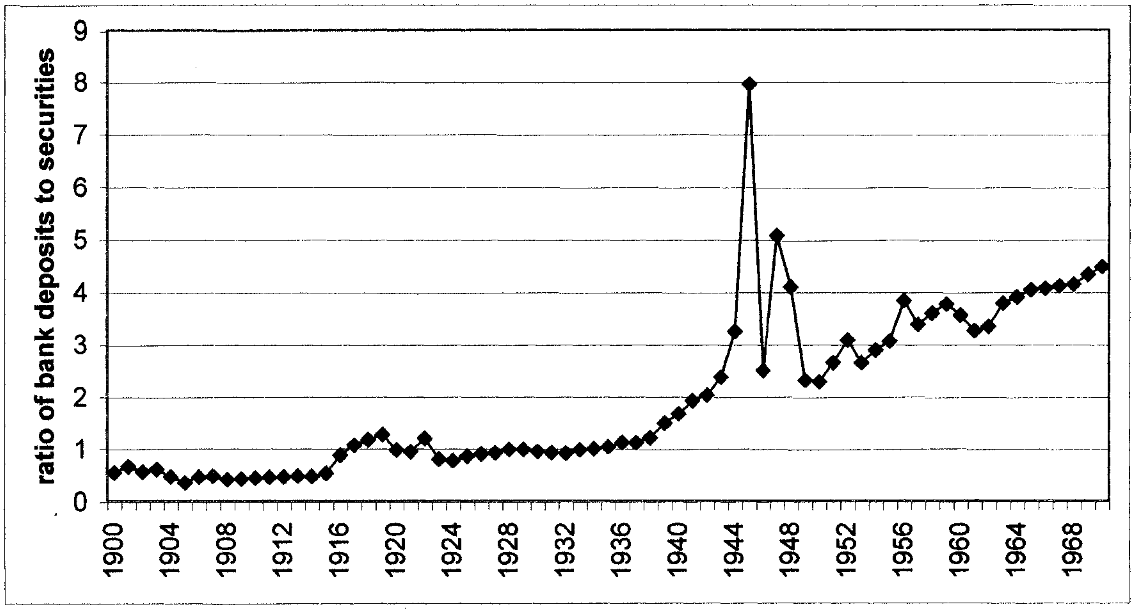
Part I. Historical Trends of the Variables

1. The Financial System

Japan's original dependence on equity finance began in 1880. After a decade of direct governmental investment in mines, railroads, and factories, the government privatized them in order to deal with pressing economic difficulties.[1] This facilitated the development of securities markets, which flourished. According to Chalmers Johnson (1982: 85), Japanese leaders "neither understood nor believed in laissez-faire capitalism, but the government's policies seemed to reassure foreigners that Japan was becoming modern (that is, like them)."

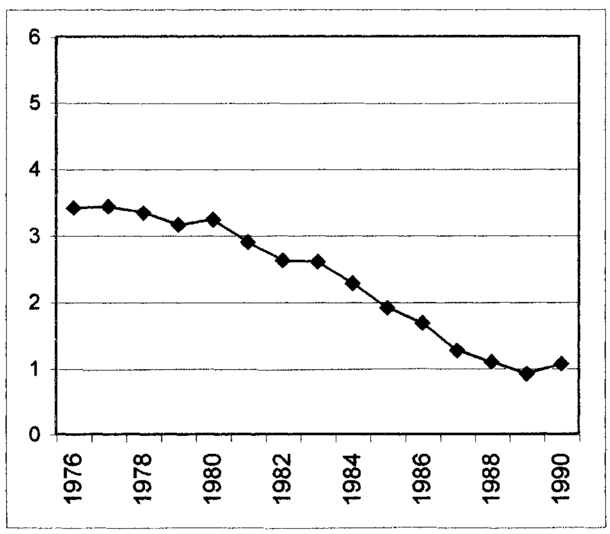
Japan remained staunchly reliant on markets during the prewar era despite momentous political and economic events. There was the Sino-Japanese War (1894-95), the adoption of the gold standard in 1897 which stopped a fall in the exchange rate but adversely affected the balance of payments thereby causing several financial crises, the Russo-Japanese War (1904-05), the postwar financial crisis in 1920 and a concomitant surge in tariffs (see figure 1.17), the Great Kantō Earthquake of 1923, a run on banks and a severe financial crisis in 1927, and the Great Depression which spread to Japan in 1930-31. Despite all of this, securities markets remained the dominant source of external finance for large firms up to the hostilities with China in 1937.

The following two figures illustrate Japan's shifting reliance on banks and markets during the twentieth century. They do not perfectly match one another since they are constructed with different measures for the structure of the financial system: the allocation of private sector assets for the first figure, and bank assets over stock market capitalization for the second. Nonetheless, the figures clearly reveal the dominant role of securities markets during the beginning of the twentieth century, followed by a dramatic switch to banking that started in 1937, and then a gradual move back toward markets in the 1980s.



Source: Hoshi and Kashyap, *Corporate Financing and Governance in Japan,* 2001.[2]

Figure 5.1: Japan: Allocation of Private Sector Assets, 1900-1970



Source: Beck, Demirguc-Kunt and Levine, "A New Database on Financial Development and Structure," 1999.

Figure 5.2: Japan, 1976-1990: Bank Assets over Stock Market Cap.

Examining a simple bank-market ratio hides important and interesting variations in banking, however. Table 5.1 gives detailed information on trends in banking during the century. The first category, commercial banks, refers to the largest banks, and savings banks which existed only before the war. The five major banks category refers to the main zaibatsu city banks, and is therefore a subset of the first category. Provincial banks are usually regulated in the same manner as the city banks, but they are not as large, and operate in local areas, primarily serving medium-sized businesses. Long-term credit banks specialize in providing five to seven-year funds to Japanese industry. The trust institutions act as a trust (e.g., pension trusts, employee benefit trusts, etc.) and as a commercial bank in offering long-term lending primarily to heavy industrial companies. The next category comprises a group of institutions that cater to farmers and small business. Notice the dramatic increase in the role played by these banks in the postwar period. The insurance companies provide further resources to heavy industrial companies, primarily with long-term lending. Finally, post offices collect deposits that are then controlled by the Ministry of Finance and its Fiscal Investment and Loan Program (FILP), which directs funds to the Japan Development Bank, the Export-Import Bank of Japan, and other government controlled financial and nonfinancial institutions.

Since the data are for deposits (liabilities) rather than loans (assets), they may offer an inaccurate picture of the total volume of lending directed to specific sectors. For example, the total financing directed to large firms, small firms and farmers is understated by looking only at their affiliated banks since they do not account for lending originating from the deposits collected by the postal savings system. Additionally, only a fraction of deposits at agricultural cooperatives may ultimately be lent to farmers (especially in the 70s and 80s). Nonetheless, since each of these institutions, except the post office, offers lending services, the data are useful in gauging the general importance of these facilities over time. More specific data on lending operations across the economy will be examined in part two.

Table 5.1: Proportion of Deposits and Financial Bonds of Various Financial Institutions in Aggregate Deposits and Bank Debentures (Percent)

	1910	1920	1930	1940	1950	1960	1970	1979	1987
Commercial banks and savings banks[1]	72.8	70.3	47.4	46.4	57.4	49.9	41.9	35	35.7
Five major banks[2]	12.7	14.4	14.7	15.5	38.3	32.8	26.2	20.5	21.4
Provincial banks[3]	60.1	55.9	32.7	30.8	19.1	17.1	15.6	14.5	14.3
Long-term credit banks[4]	14.4	14.9	13	10.4	8.9	5.7	6	5.7	5.4
Trust institutions	--	--	7.6	8.1	2.7	10.1	9.6	11.7	11.9
Mutual banks, *shinkin* banks, credit associations, including cooperatives[5]	0.3	2.2	7.1	13.5	17.4	19.5	25.5	25.1	22.7
Life insurance companies	3.8	4.4	6.6	5.6	2	4.1	6	5.7	9.3
Post Office	8.6	8.2	16.3	16	11.5	10.7	11	16.8	15
Aggregate deposits and bank debentures[6]	2,010	10,91 6	21,68 0	62,81 6	1,617	17,0 20	97,65 8	377,9 94	758,739

Source: Sakakibara, 1993, 18. For the pre-war period: H. Patrick, "Senkanki nikeru Nihon kinyu seido no seisei," in Senkaiki no Nihon keizai bunseki, T. Nakamura, ed. (Tokyo: Yamakawa Shuppansha, 1981); for the post-war period, Bank of Japan, keizai tokei nenpo (annual report on economic statistics for each year).

Notes:

1. Figures are the totals of the commercial and savings banks. There were no savings banks after the war.
2. Figures are for Daiichi, Sumitomo, Yasuda, Mitsui, and Mitsubishi before the war. The post-war figures are for metropolitan banks.
3. The 1940 figures includes Sanwa, which was created as a result of the 1933 merger.
4. The pre-war figures are for specialty banks. (tokushu ginko).
5. Including the Shoko Chukin Bank (Commerce-Industry Cooperative Central Fund) and the Norinchukin Bank (Agriculture-Forestry Central Fund).
6. Pre-war figures in million yen, postwar in billion yen.

The data presented here are meant simply to offer a brief overview of Japan's financial system during the course of the century. More detail on regulations and the reliance on bank loans versus stocks and bonds will be provided in the second part of the chapter. In particular, I will discuss and offer detailed data on large firms' increasing reliance on banks from the 1930s to the 1950s in the section on the China and Pacific Wars.

2. The Independent Variables

Prior to 1945, Japan was never a true democracy (the political institutions of the Meiji era will be examined in part two). Consequently, small farmers, small firms, and labor wielded negligible political power. Only with the advent of Japan's postwar democratic institutions did small farmers and small business acquire real political influence. In 1950, they made up nearly half of the total voting population:

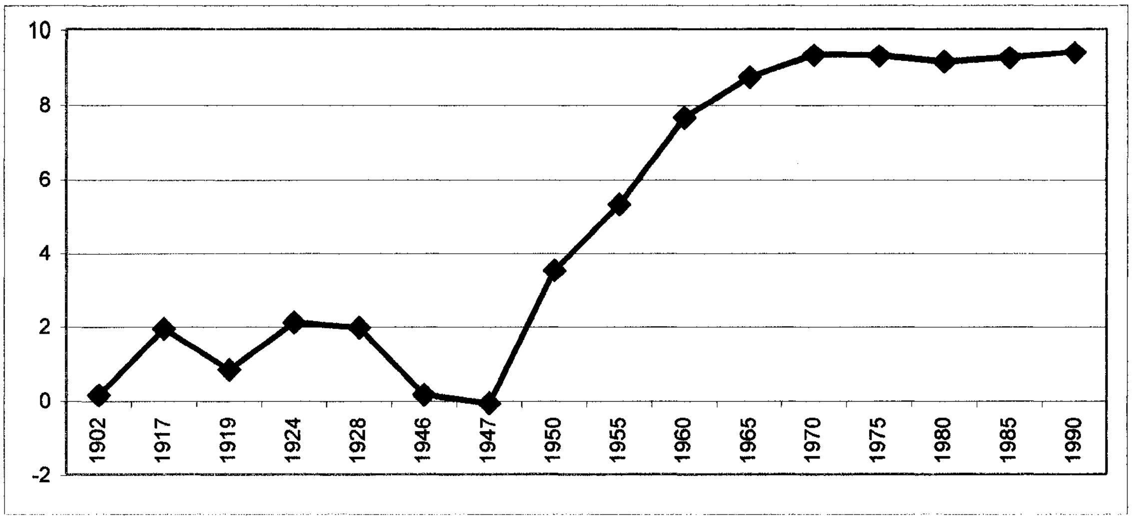
Table 5.2: Farm household voters as a percentage of the national electorate

Year	Population in agricultural electorate (A)	National electorate (B)	National agricultural electorate (A)/(B)
1950	20.1	42.1	47.7%
1960	20.1	54.3	37
1969	17.6	69.3	25.4
1980	15.9	80.9	19.7
1990	13.3	90.3	14.7
1998	12.5	99	12.6

Source: Mulgan, 2001, 304.

With such an overwhelming proportion of the electorate, agricultural interests had sufficient power to elect Diet members outright and to propose and pass legislation (i.e., overcome veto-gates). As the rural population declined, agriculture still retained considerable negative political power (i.e., the ability to ensure electoral failure if votes are redirected away from a candidate and to veto unfavorable policies).

Given their initial dominance in politics, it is unsurprising to see policy reflect agriculture's interests, including the malapportionment of electoral districts (see figure 5.3 and table 5.2), which enabled rural interests to retain their considerable political power despite a declining rural population. Wada reports, "...the apportionments before World War II were very fair, with the exception of Hokkaido, the frontier of Japan at that time." As already noted, however, Japan was not democratic. Although rural interests dominated the legislature in the prewar era, they lacked any real political power so long as the Meiji Constitution structured Japan's political institutions to privilege the oligarchy. Malapportionment became a problem after World War II, however.[3] And according to Wada, apportionment was fair up to the 1947 electoral law.[4] The following figure illustrates the change in malapportionment during the twentieth century.



Source: Wada, Junichiro. 1996. The Japanese Election System. Routledge Studies in the Growth Economies of Asia, New York.

Figure 5.3: Average Percent of Malapportionment for Lower House Elections

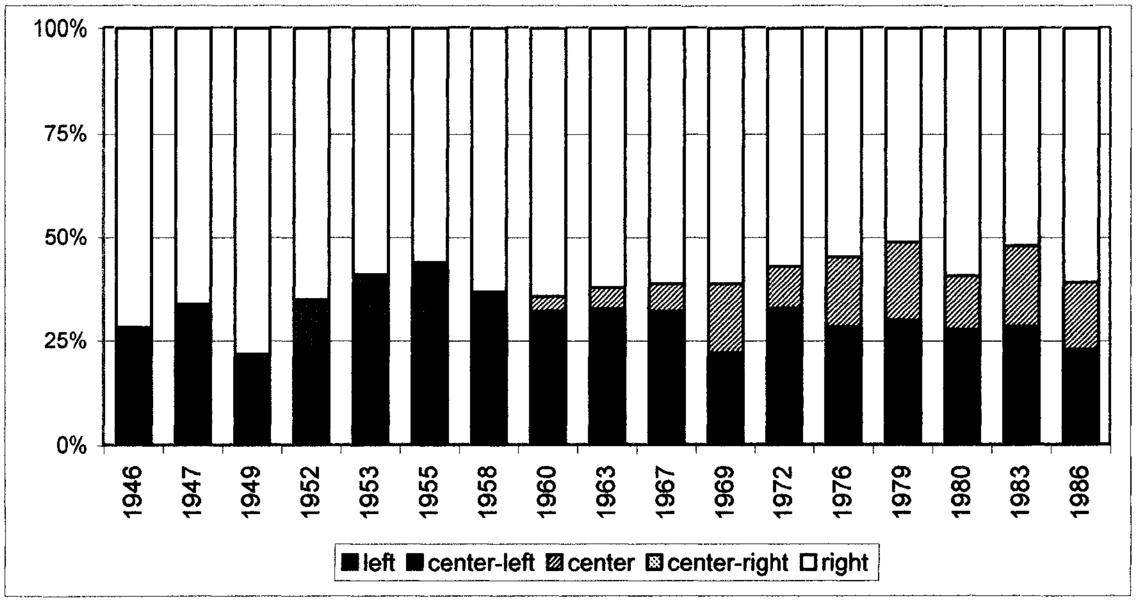
Another way to evaluate the degree of malapportionment in Japan is to look at the differences between the least and most densely populated electorates, which illustrates a similar pattern:

Table 5.3: Differences between voting values in the least and most densely populated electorates (1947-90)

	Ratio in House of Councillors prefectural constituencies		Ratio in House of Representatives constituencies	
Year	Least densely populated constituency	Most densely populated constituency	Lease densely populated constituency	Most densely populated constituency
1947	1.25	: 1	1.51	: 1
1950	1.55	: 1	2.17	: 1
1955	1.94	: 1	2.68	: 1
1960	2.39	: 1	3.21	: 1
1963			3.55	: 1
1965			3.2	: 1
1967	5.07	: 1		
1970			4.83	: 1
1972	5.01	: 1	4.99	: 1
1974	5.11	: 1	5.31	: 1
1975			2.92	: 1
1976	5.25	: 1	3.5	: 1
1977	5.26	: 1	3.74	: 1
1980	5.37	: 1	3.95	: 1
1983	5.56	: 1	4.41	: 1
1985			5.12	: 1
1986	5.86	: 1	2.92	: 1
1989	6.25	: 1		
1990	6.25	: 1	3.38	: 1

Source: Mulgan, 2001, 330.

The political power of rural interests clearly swelled following WWII. Left-wing political power also increased, but to a far smaller extent, and quickly subsided after 1947 as GHQ (General Headquarters for the American Occupation forces) sought to limit labor's political power as the US became more concerned about the communist threat. The following figure illustrates left-wing political power in the postwar era:

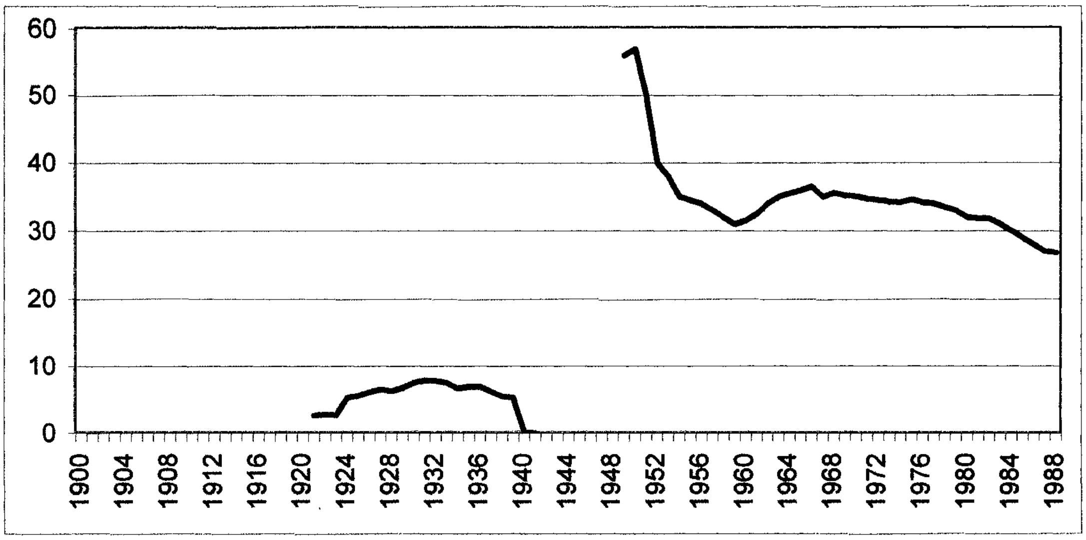


Source: Curtis, Gerald. 1988. The Japanese Way of Politics. Left = Socialists, Communists, Left Socialists, Japan Socialist Party (JSP), Japan Communist Party (JCP), Social Democratic League (SDL); Center-Left: Right Socialist, Labor-Farmer; Center = Kōmeitō, Democratic Socialist Party (DSP); Right = Liberal Democratic Party (LDP), Liberals, Democratic Liberals, New Liberal Club (NLC), Yoshida Liberal Party, Democrats, Reform Party, Hatoyama Liberal Party, Cooperative Party, National Cooperative Party, Progressives.

Figure 5.4: Japanese Lower House Election Results, 1946-86
(percentage seats to each party)

Since WWII, conservatives have dominated Japanese politics, with the LDP emerging in 1955. Within the LDP, farmers, small firms, and big business have constituted the most important pressure groups. The role of these groups in influencing LDP policy and the structure of the financial system will be explored in part two.

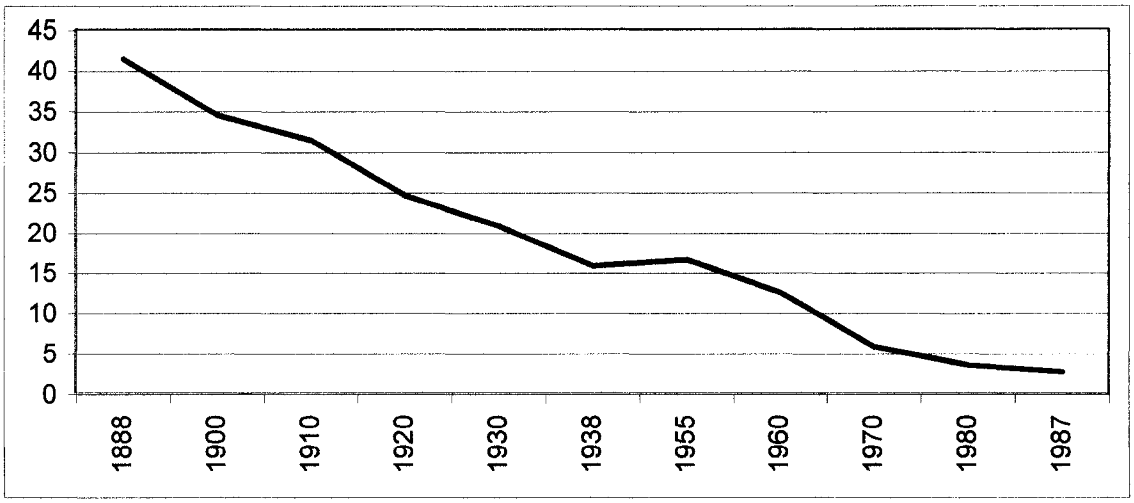
I also illustrate labor union power and agriculture's economic power. Following WWII, labor unionization rates peaked, but quickly declined and leveled out as GHQ sought to discourage their mobilization, which was subsequently assisted with laws encouraging company-specific unions rather than horizontally-organized ones.



Note: Rate of unionization = no. of union members/no. gainfully employed in non-agricultural/forestry sectors.
Source: Odaka, Konosuke. 1993. "'Japanese-Style' Labour Relations," in The Japanese Economic System and its Historical Origins, Okazaki, Tetsuji and Masahiro Okuno-Fujiwara (eds.), New York: Oxford University Press.
Original Sources: Statistical data are mainly from Management and Co-ordination Agency Statistics Bureau, *Chōki Keizai Tōkei Sōran* (Historical Statistics of Japan), vols. 1, 4 (1987-8); *Rōdōryoku Nenpō* (Annual Report on Labour Force Survey), 1989; Umemura et al. (1988); Ministry of Labour, *Rōdō Tōkei Nenpō* (Yearbook of Labour Statistics), 1987-9.
For pre-war data, also see Garon, 1987.

Figure 5.5: Unionization Rates (%), 1921-1988

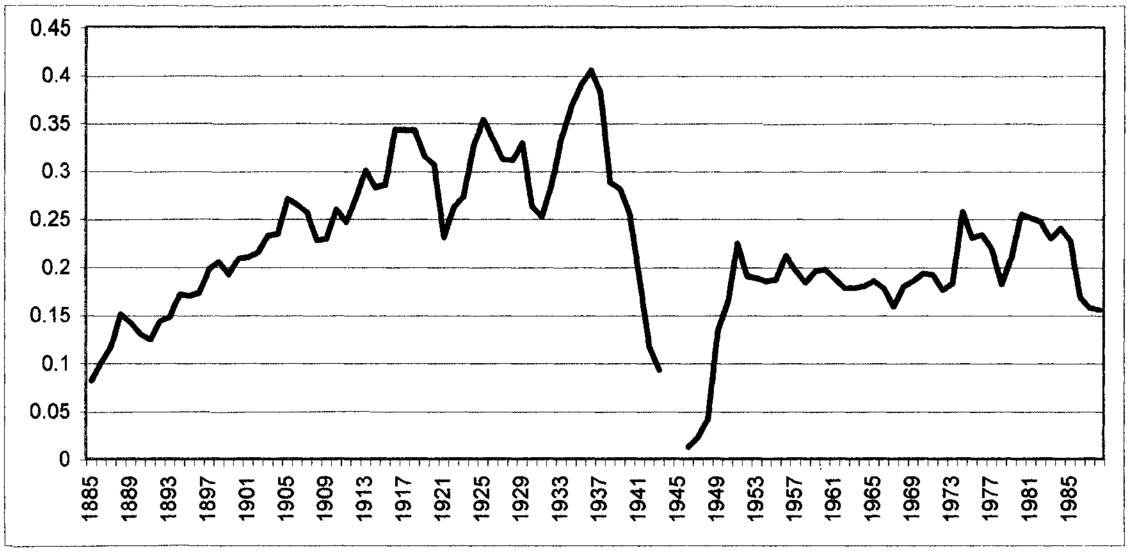
Agriculture's share of GDP has declined steadily over time.



Source: Minami, Ryōshin. 1994. The Economic Development of Japan: A Quantitative Study. Hong Kong: MacMillan. p. 92.
Original Source: Prewar Period: Ohkawa, Kazushi and Miyohei Shinohara (eds.). 1979. Patterns of Japanese Economic Development: A Quantitative Appraisal. New Haven, Connecticut and London: Yale University Press. pp. 278-80.
Postwar Period: 1953-69 – Extrapolated from the 1970 figure based on the old SNA series at 1965 prices (Ohkawa and Shinohara, 1979, pp. 281-2). 1970-89 – New SNA series (KKKN, 1991, pp. 1958-61).

Figure 5.6: Agriculture's Share of GDP (%), 1888-1987

Finally, we can look at Japan's level of openness. Notice the low levels of openness in the late nineteenth century, and the considerable fluctuations up to WWII.



Source: B.R. Mitchell, International Historical Statistics: Africa and Asia, 1995.

Figure 5.7: Japan Openness, 1885-1988
(exports + imports)/GNP

The important point to take away from this last figure is that even a closed economy, such as Japan's during the pre-1914 period, can rely predominantly on securities markets. The evidence suggests that domestic politics plays a critical role in determining the bank-market orientation of Japan's financial system.

3. Summary

The data illustrate that labor union power and farmers' political power increased considerably immediately following WWII. The former fell quickly, while the latter declined far more slowly. Although farmers' political power offers a tantalizing correlation, it is necessary to closely examine changes in Japan's political institutions since they underwent a fundamental transformation as well, and have a considerable impact on the political power of the key actors. To this end, the 1937-52 period is worth examining in detail.

Part II. Detailed Historical Analysis

The second part of the chapter is broken into three sections. In the first section, I briefly examine the period, 1889 – 1937. Specifically, I outline how the Meiji Constitution favored large landowners and big business over peasants and small firms, which gets reflected in the policy outcomes regarding the financial system. The second and third sections offer a detailed analysis of the transition period: the China and Pacific Wars from 1937 – 1945; and the Occupation from 1945 -1952. The last section considers the postwar period since 1952, in which I overview how Japan's political institutions magnified (or reduced) the political power of the key groups, and the consequences for the financial system.

1. The Prewar Era, 1889 – 1937

During the entire prewar period (1889-1937), the Meiji constitution structured the balance of power among Japan's political institutions (House of Representatives, House of Peers, Premier, Cabinet, Bureaucracy, Army and Navy, Privy Council, and Emperor). However, the relative power of these institutions, and the power of the groups within them, changed. Throughout the era, the oligarchy was the most powerful group, although they were comprised of factions that were more or less sympathetic to the interests of other political actors, such as the popular political parties, the military, big business, and the landowning elite. During the twenties, political parties gained more influence, and in the thirties, the power of the military increased until it dominated government. But to understand why particular policy outcomes resulted and how these affected the financial system, we must examine how political institutions coordinated the bargaining arrangements among actors, and privileged particular interests over others.

The Political Institutions and Interest Group Political Power

To determine which interests had the greatest influence on policymaking, it is necessary to understand the institutional structure of the government. In theory, the Emperor exercised absolute political power. The Constitution was subordinate to the Throne, and thereby to the Sat-Cho[5] oligarchs who controlled the Throne.[6] The Constitution placed the Privy Council, the cabinet, and the House of Peers effectively out of any popular control. Moreover, the powers of the House of Representatives were sufficiently limited to give popular government little positive power. It could only serve as a weak veto-gate.[7] It was weak because the oligarchs retained the ability to circumvent uncooperative legislatures: they could often avoid statutes through Imperial Orders, they could keep the budget beyond real legislative control (e.g., by implementing the previous year's budget and deflate the currency to increase its relative size), and the oligarchs could even dissolve the legislature if necessary.[8]

One of the most powerful mechanisms for undermining popular rule was the Genrō (Elder Statesmen). They made important political decisions in the Emperor's name, such as recommending the prime minister to the legislature, and served as the real centralized power of the state up to the 1920's.[9] No political institution was as powerful as the Genrō in the early constitutional period. Although they lost their influence as fewer members survived to advise the Emperor in the 1920's, the Privy Council also acted as an advisory council. These members were appointed by the Emperor for life, but the Council was a constitutionally recognized body and could more easily be reined in, unlike the Genrō.[10]

Members of the House of Peers were either appointed by the Emperor or were aristocrats who inherited their membership. The Peers often sought to protect the bureaucracy by vetoing the lower house's anti-bureaucracy legislation since all policies required concurrent Peer-House approval.

For most of the period, the House of Representatives was not popularly elected since only wealthy taxpayers were permitted to vote: usually businessmen and wealthy landowners. The Elections Act of 1889 enfranchised only 453,000 voters out of a total population of 42 million.[11] Subsequent election laws in 1900, 1919, and 1925 raised the voting population, ultimately to the entire male population aged 25 or more, totaling 12.5 million voters, or 21 percent of the population. Indeed, during the twenties, political parties' influence increased. Policy outcomes reflected more of the parties' objectives via the Diet's power to approve of the premier, who was recommended by the Emperor. Because the premier selected cabinet members, this was the Diet's one way to influence the administration. Frequently, the premier would bargain with party leaders to ensure his election, and in doing so, would offer cabinet positions to them.[12]

Within the bureaucracy, the ministers of the army and navy had direct access to the Emperor, and therefore were completely beyond the control of the prime minister. As a result, the administration of the army and navy was entirely beyond the control of a cabinet dominated by political parties. The ministers of the army and navy did not resign with a retiring premier, but continued in office in the cabinet of his successor.[13]

Thus, the lower house of the legislature had little power throughout most of the period, and was dominated by wealthy farmers and business interests. The twenties witnessed increasing party influence, but it was insufficient to dramatically alter government policies. The important point is that the levers of power were predominantly controlled by the oligarchy (the Genrō, Privy Council, and House of Peers) until the military began exercising greater control over government policy in the thirties.[14] Thus, to understand why Japan relied heavily on securities markets during this period, we must determine which interest groups most heavily influenced the oligarchs.

Big Firms

Two important factors contributed to the strong ties between the zaibatsu (big business) and the government: informal ties and the electoral system. The development of Japan's industrial and commercial sectors initially depended upon intensive government planning, supervision, and subsidization. But beginning in 1880, the government of Japan could not afford to continue these policies, which produced negative side effects such as inflation, trade deficits, corruption, and looming bankruptcy.[15] Consequently, the government began helping private entrepreneurs to accumulate capital and to invest it in ways that assisted Japan's needs for military security and economic development. The beneficiaries of this new policy were the big merchant houses of Mitsui, Mitsubishi, Sumitomo, Yasuda, Furukawa, Okura, and Asano, which later came to be known as the zaibatsu (Johnson, 1982: 85).

The relationship that developed between big business and the government was one of close, informal ties. For example, "large number[s] of new industrial leaders …

were … men whose political predilections and personal friendships—not to mention economic security—lay with the government. With Meiji political and economic elites extremely small in numbers, with the latter frequently selected by the former and having a similar background, close personalized contacts were most natural."[16] At this early date, Japanese industry was highly centralized, with the key financial-economic controls held by the government and the zaibatsu. Although small and medium sized businesses played an important part in overall production, they depended heavily on the zaibatsu and government. "The zaibatsu were leading actors in the industrial-financial scene, symbols of Japanese capitalism, and ultimate recipients of tremendous economic and political power."[17]

Since agrarian power came in the form of votes, and was therefore concentrated in the lower house, rural interests generally lacked the political power of the zaibatsu. Thus, the zaibatsu, who garnered political favors from the oligarchs through their financial influence, frequently prevailed when conflicting urban-rural interests arose, such as nominating premiers and legislation affecting the financial system.[18] For example, the Genrō's nominations of premiers illustrate their preference for business-friendly leadership. One early example is Yamagata's premiership, which began in November 1898. He allied with the Jiyūtō group of the Kenseito (the precursor of the Kenseikai pro-business party and created by the cooperation of the Jiyūtō and Shimpōtō parties) and made a bargain with them which helped to align the political parties to the growing class of capitalists.[19] Up through the 1920s, premiers were always pro-business.

Corruption was common with these business-political relationships. Big "seisho" (political merchants) such as the zaibatsu were constantly making personal gifts to party leaders and high government officials. The initiative in cases of corruption did not always rest with the business community; in fact, there were many instances in which politicians collected a forced draft from businessmen and used it for personal purposes or to bribe legislative representatives.[20] After describing a publicly exposed episode of corruption of a party leader, Scalapino remarks that "there were multifarious ways in which oligarchic leaders obtained personal funds from the capitalist class; whether it was by outright monetary bribery, shares in the company, or loans written off, they received sizable benefits." This procedure was prevalent in the bureaucracy as well. Exposés such as the Textbook Scandal, which brought the arrest of about one hundred and fifty persons, ranging from lowly examiners of texts to prefectural governors, illustrate how widespread corruption was.[21]

The second factor influencing close business-government relations was the electoral system for the lower house of the Diet. Under the electoral rules of 1900 and 1925, voters in each district were given a single nontransferable vote in selecting from among multiple candidates. This system was initially devised by Yamagata to keep parties as weak and fractious as possible.[22] The idea was to force any party seeking to win or maintain a legislative majority to field multiple candidates in most districts, thereby creating severe intra-party competition and thus be less likely to act coherently in the Diet.[23] The system would not necessarily prevent a large party from gaining a solid majority (e.g., the LDP in postwar Japan), but it would be far more difficult. Under this kind of electoral system, candidates must rely on their own personal reputation rather than that of the political party to which they are affiliated. Accordingly, they must develop a loyal base of supporters, which was accomplished by distributing pork (e.g., subsidized loans). In post-war Japan, the ruling LDP used government-dispensed pork, cash and in-kind gifts, and bureaucratic services. In pre-war Japan, the parties used very similar tactics, but likely with more bribes than the LDP.[24] In return, business would offer money to fund their campaigns, and bribes as discussed above.[25] Mitsui, for example, was a strong backer of the Seiyukai. Also backing the Seiyukai, though less faithfully than Mitsui, were the Yasuda and Sumitomo zaibatsu, along with the Asano, Ōkura, Kawasaki, Ōsaka Shōsen, Furukawa, Kuhara, Fujita, Hattori, Ōkawa, Fukuzawa, and Nakahashi groups. The Kenseikai, on the other hand, was supported by the Mitsubishi zaibatsu, and the Shibusawa, Yamaguchi, Nezu, and Hara groups as well as the Tōhō Electric power and Japan Electric power companies.[26]

Regarding the formation of securities exchanges in Japan, the first Stock Exchange Act was passed in 1874.[27] It was patterned after the rules of the London exchange, but was considered too restrictive and too different from the practices of the already extant rice and commodities markets which participants were more used to. Consequently, the government passed new legislation in 1878 which recognized many of the more familiar transaction formats. The Tokyo Stock Exchange was established in May, followed by several more exchanges in the major cities shortly thereafter. Corporate bond markets developed slowly until the 1890 Commercial Code was passed, which specified rules regarding corporate form and liability as well as guidelines regarding the issuance of bonds.[28] Both prospered. Indeed, despite the 1923 earthquake (measuring 7.9!) and the 1927 financial crisis, the government and the zaibatsu ensured that stock and bond markets recovered quickly and remained deep and vibrant. During the earthquake, for example, the Tokyo Stock Exchange burned down but was quickly rebuilt and functioning effectively within two months.[29] Banking services were largely used to bolster firms' securities markets financing activities, making bank financing "the least important source of funds" for the Japanese economy during the 1889-1937 era.[30] Thus, it appears that large firms' political power directly contributed to the extensive reliance on equity and bond financing, matching the theory's expectations.

Labor

Resembling their French counterparts, Japanese labor called for 'state management' of credit in 1927.[31] Indeed, from the founding of the Socialist Masses' Party in 1932, one of their key policies was the demand for a National Economic Congress, which would be a government organization comprised of 300 representatives from the government, the military, labor, agrarian, and business organizations.[32] In essence it was to be a national planning board, resembling France's postwar planning committees inaugurated under the labor dominated government of the Fourth Republic.

In the prewar period, however, labor had almost no influence on the financing decisions of large firms, nor on the financial system more broadly. Although labor gained some concessions during the interwar period, when it was strongest, the most significant legislation which would have legally protected labor unions, the Labor Union Bills of 1926 and 1927, were never passed by the Diet. However, the Labor Disputes Conciliation Law was passed in 1926, which established rules for conciliation committees composed of representatives from labor, management, and the public.[33] Hope was renewed with the first election, in 1928, under the Universal Manhood Suffrage Law of 1925. This pushed the Lower House of the Diet in a reformist direction, as an alliance developed between the more liberal party, Kenseikai/Minseitō, and the labor movement. The Seiyūkai was on the conservative side of the aisle. With a growing labor movement and an inchoate Communist party, the conservative cabinet minister, Tanaka, who had been appointed in 1927, used force and repression to weaken labor.

The new prime minister, Hamaguchi, came to office in July 1929 and sponsored a new labor union bill. At the same time, austerity measures were imposed to fight the downturn in the economy (with pre-Keynesian economic policies such as devaluing the yen which led to lower wages and higher unemployment), leading to increasing labor union membership, reaching a prewar high of 7.9 percent in 1931. All of this alarmed employers who mobilized to fight any new pro-labor legislation.[34] Businesses advised Minseitō leaders that the union bill stood in the way of continued industrial support for the cabinet's economic policies. This forced many party members to reconsider the costs of defending the bill, and ultimately Hamaguchi tilted to the demands of big business. A more conservative version of the bill was eventually passed by the lower house, but was subsequently defeated in the House of Peers in 1931.[35] This ended any hope of favorable legislation for labor until after WWII.

Because of the importance of labor unions' ability, and inability, to bargain with big firms in the postwar period in Japan relative to other industrialized nations, it is useful to trace the origins of its company-specific unions. Following World War I, the government made plans to set up works councils, which led zaibatsu affiliates to experiment with various kinds of company unions. To draw workers away from cross-firm (horizontal) trade unions, an increasing number of employers discussed wages, hours, and working conditions within factory councils in the latter half of the 1920s.[36]

Factory councils were partly inspired by top Japanese businessmen visiting the United States in 1921 and 1922. "They were most impressed by talks with corporate executive and Republican Party leaders in the United States. Herbert Hoover, then secretary of commerce, warned against recognizing industrial unions because workers thus organized would surely emerge victorious. Elbert Gary of U.S. Steel lectured his Japanese guests on the evils of collective bargaining and the virtues of his firm's factory councils" (Garon, 1987: 170-1). Japan's postwar enterprise-based unions, company-linked benefits, and loyalty to the firm was influenced by American employers anti-union "American Plan" and "welfare capitalism" during the 1920s. Additionally, factory councils were also promoted to prevent trade union legislation, as Garon (1987: 170) finds from rhetoric of the Japan Industrial Club in 1930 and 1931.

Given their weak political influence during the prewar era, the theory predicts and the evidence confirms that bank lending that favors labor's policy objectives would play a minor role in overall corporate financing, and in the financial system more broadly.

Farmers and Small Firms

With wealthy farmers wielding considerable political power in the lower house of the Diet from the beginning of the Meiji era, they should be expected to block legislation that could harm local banks. Peasant farmers and small firms had little political influence, and so they are expected to lack adequate funding volumes. Here, I evaluate changes in local banking generally speaking, without distinguishing between whether it served small firms or wealthy landowners. It can be certain, however, that tenants (the majority of small farmers) did not receive financing since they rented and worked the fields of the large, wealthy landowners.

One of the first attempts to limit local banking was with a bill in 1894 to limit the entry of and competition among banks by imposing minimum capital requirements. It failed to pass the lower house out of concern for preserving the number of small banks.[37] In 1896, however, the Bank Merger Act, to encourage mergers among banks, passed the lower house. This bill passed the Diet because it did not impose capital requirements, and only offered incentives for mergers, such as favorable tax treatment, but no penalties.[38] Again in 1902 and 1906, the Ministry of Finance submitted bills that would impose a minimum capital requirement, but each time the lower house failed to pass it.

Given the structure of the political institutions, the lower house could not propose and pass legislation that assisted small banks during downturns in the economy. For this reason the number of small banks fell over time, from 1,854 in 1901 to 1,537 in 1926.[39]

In 1924, the Kenseikai won a plurality of lower house seats, and formed a majority coalition with the Seiyūhontō (a splinter group of the Seiyūkai). The Kenseikai had closer ties to big business involved in international trade and investment, while the Seiyūkai was closer to small business and farmers. Consequently, the former drafted legislation to create capital requirements that would disqualify many small banks. The bill passed and was scheduled to go into effect on January 1, 1928.[40]

By January 1928, only 790 of the 1,238 banks that survived the financial panic of 1927 met the new capital requirements. The Seiyūkai now controlled the cabinet, but it lacked a legislative majority and thus could not repeal the Act.[41] By 1932, the number dropped to 683. The disappearance of small banks allowed large banks to increase their market share. In 1926, the 13 largest banks held 40.8 percent of total deposits, and the zaibatsu banks and Shibusawa's Daiichi Bank controlled 24 percent of all deposits. In 1931, the 13 largest banks held 58.9 percent of total deposits, and the big five controlled 38 percent.[42]

The Seiyūkai gained a majority in the Diet in 1932; by this time, however, the military was calling the shots regarding the banking industry. Under military government, the Ministry of Finance shifted its goals from maintaining the stability of the financial system to centralized control. To this end, it sought to reduce the number of local banks to one per prefecture, and to ensure that local banks efficiently transferred their funds to the large banks in the cities.[43] By 1938, there were only 377 banks.

Throughout the prewar period, small farmers generally faced a capital shortage and had to pay high loan rates; around 9.2% in 1929, compared with large firms' bond yields of 5.5-6%. Small firms also had very high borrowing costs relative to large firms during the interwar period; around 15% for short-term industrial loans in Tokyo in 1930.[44] Lockwood (1954) attributes these high costs of capital to both farmers and small business to a scarcity of capital, since it was being directed toward the larger enterprises.

Additionally, table 5.1 illustrates the relatively low volume of deposits and bank debentures for local banks during the prewar years in comparison to the postwar period: 3% of the total for the 1910-30 period, compared to 18.5% for the 1950-87 period. This conforms with the theoretical expectations that they would have a paucity of available funds as a result of their negligible political power in the prewar period.

2. War, 1937 – 1945

Although my theory does not address the effects of war on national financial systems, it is necessary to review this period in order to understand the origins and structure of the postwar financial infrastructure.

The military's rise to power was unintentionally begun with the Minseitō cabinet's decision to lift the gold embargo on January 11 1930. The Ministry of Finance followed by placing Japan back on the gold standard for the first time since 1917. However, the New York Stock Exchange had crashed a few months earlier and the US economy entered a deep depression, spreading around the globe. Consequently, Japan's export trade fell 27 percent from 1929 to 1930 (Allen, 1981: 107–8). Labor and farmers were especially hard hit as exports and wages dropped because of lower exports and as a result of the deflationary policies to keep Japan on the gold standard; prices on all farm goods fell an average of 34% from 1929 to 1930 (Nakamura, 1981: 216–7). The economic effects on the average worker and farmer were worse than the Great Kantō earthquake in 1923 or the financial crisis in 1927. Consequently, party government became the victim of the public's growing anger over their dire economic straits. Ultranationalism spread and resentment toward party leaders grew as they were increasingly perceived as corrupt. The military became emboldened, and Prime Minister Hamaguchi was attacked in November 1930, and later died, for supporting the London Naval Treaty over the objections of the navy. Additionally, in early 1932 a *ketsumeidan* assassinated Finance Minister Inoue in February, and Takuma Dan, a top manager of Mitsui, was killed in March. The murder of prime minister Tsuyoshi Inukai by young military officers on May 15 1932 (the May 15 Incident) marked the end of party–led government. From then until August 1945, Japan had eleven military–backed non–party governments. The next prime minister, a retired admiral, formed a "national unity" cabinet comprised of military men, in addition to party leaders and the oligarchy. Under pressure from the army, however, the cabinet recognized the puppet state of Manchukuo (Manchuria) in September 1932 and withdrew Japan from the League of Nations in March 1933. Thus, although the cabinet appeared to have multiple principals, in fact, the military increasingly dominated government policy decisions.

In July 1937, war broke out with China and the government enacted legislation mobilizing the country's resources for war. Of primary importance was the ability to direct finance. The changes made in its financial system during its war with China, and later during the Pacific War, formed the template for Japan's postwar financial system.

Wartime Finance

When the war with China began, a series of laws were passed to put the allocation and control of finance firmly under government control, resembling similar actions performed by other countries during WWII (e.g., France, UK, US, Germany, Italy). The first legislation was the Temporary Funds Adjustment Act, passed in September 1937. Its primary objective was to control long–term funds and preferentially allocate funds for war–related industries. To this end, the Ministry of Finance divided industries into three categories based on their importance to arms production, exports, and industrial expansion, and would approve requests for long–term funds accordingly. The Industrial Bank of Japan acted as the primary institution for controlling and providing credit.[45]

A second act was passed on March 24 1938 - the National General Mobilization Act - which provided the government with broad authority over the economy, including labor, materials, facilities, firms, prices, and credit. Despite considerable opposition from business interests, the act allowed the government to control management practices, the use of funds from financial institutions, and the distribution of profits.[46]

In April 1939, the government was granted the authority to direct credit to specific firms through the IBJ (via the MOF) with the Corporate Profits, Dividend, and Fund Raising Ordinance (issued under NGMA Article 11). Also issued with article 11 was the Bank Funds Utilization Ordinance of October 1940. This allowed the government to issue directives regarding both short and long–term credit and to direct lending by banks other than the IBJ.[47]

As military firms grew during the war with China, their financing needs exceeded what one bank could provide. This led to the creation of lending consortia, which were an important precursor to the postwar lending syndicates (Teranishi, 1994). At first they were informal arrangements, but were formalized in August 1941 with the creation of the Emergency Cooperative Lending Consortium by the ten leading city banks under the leadership of the IBJ. The activities of this consortium were absorbed by and expanded with the establishment of the National Financial Control Association in April 1942. Chaired by the governor of the Bank of Japan, it served as a central coordinating agency, promoted mergers, and assisted with joint financings.[48]

With the commencement of the Pacific War, controls over the economy were increased with the Munitions Companies Act in October 1943. The creation of the Munitions Ministry with this act put major companies that were considered strategically important under the centralized and direct control of the government. Under the Munitions Companies Designated Financial Institutions System begun in January 1944, a major bank was assigned to each munitions company to provide necessary financing. Larger firms often had more than one bank assigned to them, and munitions companies never had to worry about obtaining financing through their assigned bank.[49]

Through all of this, banks were consolidated. The 424 ordinary banks at the end of 1936 were reduced to 186 in 1941, and further consolidated to just 61 in 1945.[50] In May 1943, ordinary banks were granted the right to collect small deposits, causing the number of savings banks to fall from 69 in 1941 to 4 in 1945. More important, however, were consolidations among the zaibatsu banks, with four major zaibatsu banks controlling almost half of the capital of Japan's financial institutions in 1945.[51] The following tables illustrate the relative size of the five largest banks and the sources of external funds for industries, demonstrating the concentration of banking that occurred and the increasing reliance on banks for external finance.

Table 5.4
Relative Size of the Five Largest Banks
(In percent of totals for all ordinary and savings banks)

Year	Paid-in Capital[a]	Deposits	Lending
1900	5.4	15.1	10.6
1910	10.2	17.4	15.1
1920	13.9	20.5	16.5
1930	24.1	31	27.6
1940	31.6	35.4	44.7
1945	40.4	45.7	58.6

Note: The five largest banks were Mitsui, Mitsubishi, Sumitomo, Dai-Ichi, Yasuda until 1942. In 1943 Mitsui Bank and Dai-Ichi Bank were merged as Teikoku Bank, which absorbed Jûgo (Peers) Bank in 1944. Thus, the 1945 data for four banks. Teikoku was split back into Mitsui and Dai-Ichi in 1948.
Source: Teranishi (1982, p. 295), and Hoshi and Kashyap.
[a] Paid-in Capital is capital received from investors in exchange for stock.

Table 5.5
Sources of External Funds for Industries: 1931-57
(Percentage distribution of total)

Year	Total (¥ million)	New Share Issues	New Bond Issues	Net New Bank Loans
1931	361	56.5	29.92	13.57
1932[a]	-265	-	-	-
1933[a]	-53	-	-	-
1934	968	122.52	6.3	-28.82
1935	1,199	68.06	2.17	29.77
1936	1,562	63.76	-4.35	40.59
1937	3,733	53.2	-0.19	46.99
1938	4,598	49.72	7.76	42.52
1939	6,930	33.62	10.82	55.56
1940	7,653	38.42	7.96	53.63
1941	8,041	43.81	15.23	40.95
1942	10,518	37.36	12.95	49.69
1943	12,184	32.47	11.23	56.3
1944	19,225	11.98	10.91	77.11
1945	50,405	6.11	0.64	93.24
1946	59,153	7.63	-2.08	94.44
1947	133,403	6.77	0.01	93.22
1948	437,703	13.56	0.05	86.39
1949	491,837	22.07	3.04	74.89
1950	512,898	6.22	8.48	85.3
1951	957,775	7.27	3.76	78.53
1952	1,021,295	11.98	3.63	84.39
1953	1,063,275	15.59	3.87	80.53
1954	611,959	23.23	3.01	73.77
1955	676,471	14.12	3.92	81.95
1956	1,416,590	12.53	4.06	83.41
1957	1,798,253	15.88	2.91	81.2

Note: Negative numbers mean more bonds or loans were repaid than were issued.
[a] Because of the large retirement of debt (especially loans, but also bonds) in 1932 and 1933, firms actually paid out more in total than they took in as external finds, so the percentages are no meaningful. In both years, new shares were issued: about ¥108 million in 1932 and ¥315 million in 1933. Bank loans fell ¥287 million in 1932, ¥328 million in 1933, and ¥279 in 1934.
Source: Bank of Japan, *Statistical Annual*, 1960. Hoshi and Kashyap, 2001.

In addition to legislation encouraging the concentration and reliance on bank financing, the government sought to discourage equity and bond financing, and shareholder influence. With the 1937 Temporary Funds Adjustment Act, stock issues were subject to government control, and corporate bond markets were suppressed. For industrial firms, Adams (1964: 143) shows that new stock issues fell from 60% to 75% of net funding in 1935 and 1936 to below 20% in 1944-45. Corporate bond financing for industrial firms never rose above 15% between 1937 and 1945. Additional restrictions occurred with the Corporate Profits, Dividend and Fund Raising Ordinance of April 1939, which forbade firms with capital above ¥200 thousand to raise their dividends above the level of November 30 1938. The Control of Corporate Finance and Accounting Ordinance of October 1940 imposed further restrictions by requiring government approval for dividends above 8%.[52] The ordinance also permitted the government to determine how internal funds could be used – for example, by requiring the purchase of government bonds. Consequently, shareholders now resembled debt holders since their income was fixed in nominal terms and they had no effective residual claim on earnings.

By the end of the war, bank-firm relationships were solidified and assigned banks dominated firms' external financing needs; capital raised on securities markets (bond markets in particular since the stock exchange had been closed) fell to a trickle.

3. Occupation, 1945 – 1952

The Occupation period is important to Japan's longer postwar history because the democratic political institutions were put in place at this time, and additional laws were made affecting the political power of labor, farmers, and small and large firms. The ways in which political institutions mediate the political power of these groups has had profound consequences for the structure of Japan's financial system during the postwar era. First, I briefly discuss the financial system during the Occupation and save a more thorough discussion for the section on the post-Occupation period since the financial system will have settled into a more clearly identifiable structure. Next, I examine changes in the political power of farmers, labor, and big firms, and then investigate the origins of the postwar electoral system. A discussion regarding small firms is also saved for the post-Occupation period section since they wielded little political influence during the Occupation.

With regard to expectations governing the financial system, the most crucial aspect of Japan's financial system was capital scarcity and the need to rebuild basic heavy industries. Thus, for several years following the war, it is likely that banks would be heavily relied upon, following the pattern seen in France (and other European countries such as Italy, Germany, and the UK). Among banking institutions themselves, there is likely to be some variation at the margin corresponding to the political power of each actor.

The Financial System

During the Occupation period, banks often intervened in the affairs of clients when they fell into financial trouble; the credit crunch in particular forced banks to dramatically increase their role in corporate governance.[53] Hoshi and Kashyap find that the relations formalized by the munitions companies system of WWII (where a bank is assigned to a particular firm) lasted into the postwar period. Even after 30 years (1974), 79% of 157 munitions companies from WWII still had close ties to their designated wartime financial institution, suggesting that the wartime transformation was very important to the structure of the postwar banking-oriented financial system. Moreover, because the designated institution typically had been involved in a firm's postwar reorganization, Occupation period policies further cemented the relationships.[54]

The stock exchanges had suspended trading even before the war ended and they remained shut until May 1949. The corporate bond market was also of limited importance during the first few years after the war; government bonds were absorbing the available demand. Bond markets were eventually reopened in 1949, but both the stock and bond markets were tightly controlled, and their use limited.[55]

Farmers

During the war, the government controlled the production and distribution of food. This system of monopoly control was established when, in 1943, agricultural associations and cooperatives were amalgamated into a single system of national, prefectural, and village farm organizations. All farmers and landowners were required to join. As stipulated by the Agricultural Organizations Law, the new system of rural organizations would operate "in perfect compliance with national policy."[56] This law also brought agricultural collection and distribution organizations under a single umbrella—the nogyokai (agricultural societies). In the same year, the Central Bank for Industrial Cooperatives became the Central Bank for Agriculture and Forestry (Norin Chuo Kinko, or Norinchukin).[57] These came to occupy a central role in the administration of agrarian finance in the post-war period.

Immediately after the war, land reform measures were introduced by SCAP (Supreme Commander of the Allied Powers) officials, who feared that the revival of the tenancy system could lead to a relapse of authoritarianism or a communist insurgency among landless farmers. SCAP also viewed land reforms as critical to the democratization effort.[58] A dramatic restructuring of landholdings in rural Japan ensued. At the end of the war, tenants cultivated 45 percent of arable land; by 1950, tenants cultivated only 10 percent. Likewise, the number of farm families that owned 90 percent or more of their land increased from 1.7 million to 3.8 million.[59] Consequently, farmers' political demands shifted from the redistribution of land to concerns over prices, access to productivity-increasing inputs (e.g., access to cheap capital), and improvements in the quality of rural life. With regard to the argument of this dissertation, there should be an increase in the number of rural banking facilities as a result of their considerably enhanced political power.

During the war, cooperatives were part of the Imperial Agricultural Association (IAA). As an instrument of government control over agriculture during the war, the IAA was tainted by authoritarianism in the eyes of SCAP officials, and in 1947 Occupation authorities ordered its dissolution. Under the Agricultural Cooperative Association Law passed in December 1947, local cooperatives were reconstituted as a private, voluntary organization—the Nokyo. Despite this new legal authority, few practical changes occurred. Critically, the cooperatives retained their central role in the food control system and took over the membership, assets, and operations of their wartime predecessors.[60]

Following the passage of the Agricultural Cooperative Association Law (or Nokyo Law), the number of local nokyo proliferated rapidly – from 4,256 in April 1948 to 14,120 in August and 27,819 by December. As the farmers' unions retreated, the agricultural cooperatives became the dominant force in the villages. Norinchukin was also reorganized with an increase in its capital on April 1, 1948.[61]

Article 10 of the Nokyo Law itemizes the 'businesses' that agricultural cooperatives or federations of agricultural cooperatives may undertake. This included supplying the necessary funds for a member's business or livelihood (credit business) as well as receiving members' savings or fixed deposits. Under Article 10, Paragraph 7, Nokyo were permitted to supply credit to local public organizations, banks, or other banking institutions.[62]

Consequently, Nokyo garnered tremendous political and economic power at the local level. The cooperative banks collected government payments received by producers. These government transfers, in turn, fueled the expansion of cooperative activities in other areas. According to a 1951 SCAP publication, "In most villages, general-purpose cooperatives now provide the primary credit, marketing, purchasing, processing, and other essential services used by farmers." With 90 percent of all farm households represented by at least one cooperative member, Nokyo was the most important organization in rural Japan.[63]

The political instability of the 1945-1950 period offered the agricultural cooperatives a golden opportunity to establish themselves as a potent political force at the 'rice' roots level. According to Masumi, "As the largest organization in the countryside, Nokyo possessed the ability to mobilize votes and exhibited its influence in national as well as local elections. There were frequent instances in which the position taken by Nokyo determined the success or failure of a given candidate. Furthermore, Nokyo executives made use of their vote-gathering capacities to enter and win national and local elections."[64] Such effective vote mobilization at the local level is echoed by Ronal Dore, who remarks that "even the mere word, spread around the village, that…the Co-operative president…'is for [a given candidate]'…may influence…votes."[65] In short, cooperatives became an essential component of every rural politician's reelection constituency, and considerably enhanced credit availability to small farmers.[66]

Big Firms

GHQ viewed the business elite within Japan as having been strong proponents for the war effort. Consequently, they sought to eliminate the zaibatsu, thereby ending the dominance of a small group over a large number of firms, and to decrease concentration by limiting the size of any one firm within its industry.[67]

Although zaibatsu dissolution was originally envisioned to include 83 companies, in the end only 30 firms, including the big four (Mitsui, Mitsubishi, Sumitomo, and Yasuda), were dissolved. "The others were required merely to eliminate their holding-company structure. Further, the zaibatsu financial institutions emerged from the process completely unscathed. However, the prewar structure of the zaibatsu – characterized by holding companies, layers of subsidiaries, and family stock ownership – was largely ended."[68] With regard to deconcentration, this effort was even weaker. Only 18 companies, out of an original 325, were broken up under the Deconcentration Act.[69] In the end, dissolution and deconcentration efforts were weakly implemented, permitting the evolution of zaibatsu into keiretsu, and for these large conglomerates to have considerable influence in the Japanese economy and in politics.

During the immediate postwar years (1945-9), direct credit controls were used. The Reconstruction Bank played a crucial role in rebuilding Japan's basic industries, and late in 1948, it had become by far the largest supplier of capital for the coal, iron and steel, fertilizer, electric, shipping, and textile industries. As of March 1949, the loans made to these sectors amounted to a large proportion of the total investment made by each of these selected industries.[70]

Table 5.6: Proportion of Capital Supplied by the Reconstruction Bank as a Percentage of Total Investment Made by Various Industries Between September 1947 and March 1949

Industries	Coal	Iron, Steel	Fertilizer	Electric	Ship-Building	Textile
Proportion of total by the bank	98.1	73.4	64	92.9	84	44.9

Source: Yamamura 1967, 28. Also, computed from the Ministry of International Trade and Industry, White Paper, 1958, p. 53; and T. Miyashita, "Reconstruction of Zaibatsu," Nippon Shihon Shugi Taikei (The System of Japanese Capitalism) (Tokyo, 1957), p. 91.

The total loans made by the bank amounted to 74.1 percent of the total investment of all industries, and 84 percent of the bank loans were concentrated in the aforementioned industries.[71] Smaller firms received only 9.9 percent of the total.

Although direct controls were lifted in 1949, financing continued to go predominantly to heavy industry. From 1949 to 1952, 90% of the funds collected from the Counterpart Fund (derived from the sale of American aid to Japan) for fixed investment in private industry went to coal, electricity, marine transportation, and iron and steel. They also absorbed 43% of all loans made for fixed investment by the commercial banks to every branch of enterprise, including agriculture. The Japan

Development Bank, which replaced the Reconstruction Bank in 1951, devoted 84% of its total loans to the 'Big Four' – as these industries were called – in the years 1951-55.[72]

The early concentration of investment in these sectors, coupled with the powerful position of the city banks, inevitably produced an industrial and financial pattern which closely resembled the wartime banking-dominated system.[73] And as we saw for France, capital scarcity and the necessity of rebuilding basic infrastructure forced the government to direct available credit, via banks, to essential industries.

Labor

In July 1944, Nosaka Sanzo (a leading Communist) published "An Appeal to the Japanese People" which served as the basis for the Emancipation League (formerly the Anti-War League), founded in 1944. The League's program was couched in moderate language so as to appeal to a wide audience, but among its key policy prescriptions, it advocated "maintaining and strengthening state control over banks" (Colbert, 1952: 64). The program served as the ideological basis for a large segment of the postwar labor movement.

The more moderate Socialists, in 1946, proposed a system of state control of key industries (Colbert, 1952: 88), as well as the establishment of a Supreme Economic Council to determine general economic policies, subsidiary councils for each industry, and at each level of planning or supervision trade-union representatives, as well as representative of business and government would participate.[74] The long-term financial program of the Socialist Party called for the socialization of all banks and insurance companies, entailing the establishment of a Banking Control Committee to be headed by the Finance Minister and to be responsible for the utilization of funds. Additionally, it proposed that half of each banks' managers would be selected from among its employees.[75] The resemblance to France's postwar Socialist policies is striking.

The labor movement surged immediately after the war. In December 1945, 380,000 workers were members of labor unions, swelling to 900,000 in January 1946. The prewar Sodomei, or Japan Confederation of Trade Unions, was revived by social democrats and other moderate left-wing organizers in August 1946, and soon numbered 855,000 members. In late August, Communist activists organized the Congress of Industrial Organizations (Sanbetsu Kaigi), which had 1,630,000 members. Another national organization, the Japan Congress of Trade Unions (Nichiro Kaigi), and a number of independent enterprise-wide federations of local labor unions in large multi-plant companies such as the steelmaker Japan Steel Tube (Nippon Kokan, or NKK Corp.) were established as well.

At first, GHQ actively promoted labor unions, but as the Cold War began and the communist threat increased, GHQ modified its policies. After ordering the cancellation of the General Strike on February 1, 1947, General MacArthur directed Prime Minister Yoshida to hold a general election in April in order to alleviate social unrest. The JSP's (Japan Socialist Party) subsequent election victory brought Japan's first Socialist government to power (Koshiro, 2000: 20); they won a plurality of seats, but the right-wing combination of Liberal and Democratic Parties prevented any effective left-wing legislation from being passed. GHQ became increasingly worried about the rise of communism and the growing strength of labor, so as of July 1948, national civil servants were deprived of the right to strike via a change in the National Civil Service Law.

The election on January 24 1949 shattered the Socialist Party, whose seats fell from 143 to 48 in the Lower House, while the Communist Party was strengthened, winning 35 seats and nearly 10 percent of the vote. The overall result, however, was a swing to the right and Yoshida became premier of the new post-election government. Yoshida now moved the anti-union struggle into high gear. This took two forms: (1) extensive subversion of left-wing unions from within, via 'democratization leagues' or *mindō*; and (2) an 'anti-inflationary' policy, one of whose chief features was wholesale dismissal of militant workers.

The implementation of the Dodge Plan led to firings and layoffs on a large scale - causing the elimination of a large sector of the militant left - and to the reorganization and strengthening of oligopoly capital. Although the Dodge program involved expanding big industry and therefore employment in big industry, the reorganization was used carefully to weed out militant workers and to weaken the union movement. In 1949 alone, 435,465 workers were dismissed from their jobs, and around 300,000 more in 1950. In the same period, the number of unions declined by over 5500 and union membership fell by 880,000. The government purges were accompanied by direct promotion of the anti-communist *mindō* (Halliday 1978: 217-20).

As the old workers union (Sanbetsu) and the left were gravely weakened, the Yoshida government, the Employers' Federation (Nikkeiren) and SCAP worked towards a new union coalition based largely on the *mindō*. The new federation, Sōhyō, was founded in July 1950, immediately after the purge of the Japan Communist Party and the start of the Korean War. As the head of Sōhyō wrote in 1965: "the history of the foundation of Sōhyō is closely connected with the fight against the domination of the

Japanese trade unions by the Communist Party" (Halliday 1978: 220). Just after the formation of Sōhyō, Sanbetsu membership dropped to 47,000 and in 1953 it went down to 13,000. The Federation was dissolved on February 15, 1958. Sōhyō's domestic platform and the wrecking of the Sanbetsu were a big victory for business in imposing the seniority-wage system and intra-enterprise unions (Halliday 1978: 220). The left was never able to implement policies that would establish governmental control over banks to the benefit of labor despite the initial surge immediately following the war.

Political Institutions

Following the war, GHQ initially rejected Japan's prewar electoral structure (the single nontransferable vote, multi-member system) because they thought that it may have contributed to the rise of militarism (McCubbins and Rosenbluth, 1995). In its place, SCAP introduced a proportional representation electoral system in 1946 in order to encourage new political forces as part of the democratization effort; this was also the favored electoral system of the Socialist Party. Because a large number of Socialist representatives won seats in the 1946 election (93 out of 464 seats), MacArthur relented to Liberal Party leader Yoshida's request to return to the prewar electoral system.[76] The conservative Liberal and Democratic parties, which together comprised a Diet majority, revised the election law to reinstate the 1925 multimember district system. Despite this revision, neither party did as well at the polls in 1947 as was expected, and the Socialists actually took the lead with 143 seats over 131 for the Liberals and 124 for the Democrats. The conservative parties, however, rebounded by the next election in 1949 (Cowhey and McCubbins, 1995: 37-8).

The multimember system was used for all of Japan's legislative elections up until the electoral reforms in 1993, thus it is necessary to understand how it magnifies or diminishes groups' political power. As discussed in chapter two, candidate-centered electoral systems such as Japan's single nontransferable vote multi-member system (SNTV) create incentives for politicians to develop a loyal group of supporters by wooing them with pork in exchange for votes. Journalistic reporting as well as scholarly analyses (e.g., Cox and Thies, 1998 and 2000) of Japanese elections invariably focus on individual candidates' support networks and the enormous sums of money needed to build and maintain them (Cowhey and McCubbins, 1995: 43). In exchange for loyal electoral support, politicians will seek to offer favors via government regulations and the bureaucracy (e.g., Fukui and Fukai, 1996). With regard to the United States, Fiorina (1977) argues that bureaucracies can be designed to create opportunities for legislators to intervene personally on the behalf of individuals or groups of constituents, thereby allowing legislators personalized, credit-claiming activities that can help build personal vote coalitions (Cowhey and McCubbins, 1995: 44). "The party in control of the government has, of course, a distinct advantage in creating personal vote coalitions for its candidates because it monopolizes policy and budgetary favors. As long as the majority party can pass its legislation through the parliament and can direct bureaucrats effectively, it can enact (or have bureaucrats implement) particularistic policies that facilitate the creation and maintenance of personal vote coalitions" (Cowhey and McCubbins, 1995: 44). Some of these particularistic policies may include subsidized lending and other forms of financial assistance. To direct these financing favors to specific recipients, intermediaries are relied upon.

As a consequence of this electoral system, big business is favored since they offer financial backing to candidates' campaigns. Farmers and small business also benefit since they form strong local support groups. As a result of the democratic reforms privileging farmers and small firms, there should be a sizeable increase in local banking facilities in the post-war era. Politicians likewise have a strong incentive to cater to the financing preferences of big business: banking if/when they are uncompetitive in their main foreign markets (e.g., US); markets when they are competitive.

4. The Post-Occupation Era, 1952 – 1990

Following the capital shortage and system of directed finance during the Occupation, the postwar electoral system created incentives for politicians to favor local support groups with 'pork'; consequently, there has been a clear and pronounced bias toward local government expenditures and financing institutions that cater to local business such as farmers and small firms in comparison to other industrialized nations.[77] The following table gives more detail on postwar banking institutions that service small firms and agriculture than that available in table 5.1. Specifically, the mutual loan and savings banks (or *sogo* banks) are large lenders to small businesses (wholesale, retail, and construction firms), supplying them with 15% of their loans in 1980. The credit associations are similar to credit unions in western countries; their capital is derived from fees paid by association members and deposits and lending are offered primarily to members. Their operations are highly localized and target the same clients as the *sogo* banks. Rural financial organizations are comprised of institutions serving farmers (the Nokyo: agricultural cooperatives), fishermen (the Gyoko: fishery cooperatives), and foresters (Shrinrinkumiai: forestry cooperatives). Nokyo are by far the largest of the three, with 72.1% of all loans made through these institutions in 1980.

Table 5.7: Changes in the shares of total employable funds of Japanese financial institutions 1955-80

	1955	1960	1965	1970	1975	1980
City banks	33.1	29.7	24.9	22	19.3	16.5
Local banks	16.1	15.5	15.5	14.1	13.5	12.6
Long-term credit banks	4.6	5.1	6.1	5.7	5.7	4.8
Trust banks	4.4	7.6	6.9	7.3	7.2	7.2
Mutual loan and savings banks	5.7	5.8	7.2	6.1	6.2	5.7
Credit associations	4.0	5.1	7.5	8.1	8.2	7.7
Rural financial assns.	5.3	4.4	7.1	7.9	8.0	7.4
Insurance companies	3.5	4.6	6.0	7.1	6.6	7.1
Trust Fund Bureau (postal savings)	11.6	10.3	8.8	10.6	13.1	17.4
Others	11.7	11.9	10.0	11.1	12.2	13.6
Total	100	100	100	100	100	100

Source: Bronte, Stephen 1982. *Japanese Finance: Markets and Institutions*, p. 15. Original Source: Bank of Japan.

In addition to the dramatic increase in local banking for farmers and small firms, politicians' heavy reliance on campaign funds from big business creates incentives for them to cater to large firm financing preferences depending on their competitiveness in their main foreign markets (subsidized bank lending if uncompetitive and markets if competitive).

Farmers

Farmers have benefited from two kinds of financial assistance: postal savings offices for their deposits and subsidized lending. The postal savings system caters to agricultural and local sectors in rural areas in particular.[78] Its nation-wide, low-cost network and its savings instrument—the fixed-amount deposit—has made it a popular choice. The fixed-amount deposit allows deposits made in periods of high interest rates to continue to receive the same rate of interest for ten years. This feature enables postal deposits to serve a function similar to long-term government bonds. At the same time, the deposits can be withdrawn any time after six months at no capital loss (Sakakibara, 1993: 50).

The 18,000 special post offices act as the backbone of postal savings operations in Japan, and "the majority of postmasters see postal savings and not postal or postal insurance services as their main area of activity" (Sakakibara, 1993: 49). Because of the importance attached to postal services, postmasters for special post offices are often chosen on a hereditary basis, and are likely to be influential figures in their community. For this reason, the transfer of postmasters at special post offices is rare, and such stability allows for close relations with the local community which in turn creates a formidable ability to collect deposits at the local level. Because of their standing in the community, postmasters also wield considerable political power due to their ability to deliver votes at election time (Sakakibara, 1993: 49).

The second mechanism by which rural areas have received financial support is with subsidies. The Yoshida government centralized the nokyo administrative structure, enabling subsidies to be directed to agricultural cooperatives and local authorities (Calder, 1988: 260-1). Ever since, subsidies have been the characteristic administrative mode of support to agriculture in Japan, in contrast to government loans, the major means of support to small business. The framework for offering agricultural subsidies through cooperatives was established under the Land Improvement Law of 1949 and through the

Law for the Reconstruction of Agricultural Finances in 1951. During the 1949-53 period, subsidies more than tripled to ¥55.6 billion, bolstering the reliance on agricultural cooperatives as politically useful intermediaries.[79]

During most of the 70s and 80s, Japanese agricultural spending has been higher than that of any other major industrialized nation, as seen in the following table. These subsidies have come in the form of a variety of specialized programs, designed primarily to cater to the constituent interests of Japan's Dietmen from rural or semi-rural districts. In early 1983, 195 LDP Dietmen, or 68.2 percent of the ruling party members in the Diet, were members of the LDP's Agricultural Committee – the highest participation rate on any LDP committee.[80] But, as these declining numbers suggest, the LDP has been moving away from its reliance on agriculture for its core electoral constituency, and replacing it with other kinds of small business.

Table 5.8: Japan's Bias toward the Countryside: Agricultural Spending as a Proportion of Total Government Expenditures in Major Industrialized Nations, 1971-1984

	1971	1974	1977	1980	1983	1984
Japan	12.0	10.5	7.9	4.9	3.8	3.5
France	3.3	3.8	3.7	1.4	1.2	1.1
Britain	--	4.0	1.5	0.9	0.6	0.5
United States	2.0	0.8	1.4	2.9	4.0	3.1
West Germany	3.8	1.6	1.1	1.0	0.8	0.8

Source: Calder, 235. Original Sources: OECD, National Policies and Agricultural Trade (Paris: OECD, 1987), p. 129; and Ministry of Finance, unpublished data.
Notes: (1) Existence of the Common Agricultural Policy (CAP) makes precise Europe-Japan comparisons difficult. (2) European community agricultural expenditures rose by around 15 percent during 1980-84 in constant prices, while those in Japan fell in real terms, suggesting that the gap in relative EC and Japanese commitment to agriculture was closing during the early 80s. (3) Figures include processing, marketing, and consumer aid, 54.6 percent of the U.S. total during 1979-81, and only 1.6 percent in Japan.

Small Business

Japan's small-scale enterprise sector is large in comparison to other advanced industrial societies too. In 1982, self-employed workers and unpaid family workers constituted a far larger proportion of the labor force in Japan (29%) than in France (17%), Germany (14%), the United States (9%), or the United Kingdom (8%).[81]

One of the most common types of small business support policy is preferential access to capital. Japanese commercial banks generally prefer lending to large, rapidly growing firms in capital-intensive industry, and have been more reluctant to lend to small firms.[82] Japanese national fiscal and monetary policy coordination throughout the high-growth period created problems for small firms, especially as capital was directed toward the large firms. Hugh Patrick points out that credit restraint was the primary tool employed by the financial authorities in dealing with balance of payments deficits and inflationary pressures during the high-growth period.[83] During such periods of tight credit, banks would demand that marginal borrowers provide large "compensating balances," or mandatory savings deposits at low interest, in return for the opportunity to borrow. Small businesses in particular have suffered from this practice, especially during the 1950s when the government would rarely intervene. But during former Prime Minister Tanaka Kakuei's tenure as minister of finance (1962-65), the MOF began a sporadic but often aggressive intervention with respect to private banks, pressuring them to either eliminate compensating balances or at least modify their terms.[84] Three government financial institutions have also participated in increasing lending volumes to small business: the People's Finance Corporation, the Small Business Finance Corporation, and the Central Cooperative Bank for Commerce and Industry.

Founded in 1949, the People's Finance Corporation (PFC) primarily supplies funds to the smallest enterprises. To effectively fulfill its mission, the PFC created the 'no-collateral loan' program in 1973, which supplies funds mainly to factories of less than twenty workers and to service businesses of less than five employees. With no-collateral loans its major financial product, the PFC has been hugely successful: by 1986 the PFC's annual loan volume nearly equaled that of the Export-Import Bank of Japan (Calder, 1988: 318-9).

Founded in 1953, the Small Business Finance Corporation (SBFC) complements the services of the PFC by providing long-term working capital necessary for modernization and rationalization. More closely linked to the industrial policy process than the PFC, the SBFC focuses on lending which fulfills government policy objectives, such as pollution control, energy conservation, and productivity enhancement. For example, the SBFC played a major role in the rationalization of the Japanese auto parts industry during the late 1960s, an important step in the automobile industry's course to global competitiveness.[85]

The third government-affiliated small business bank, the Central Cooperative Bank for Commerce and Industry, was founded in 1936. It provides finance mainly to business cooperatives and their members, especially in geographically concentrated industries, such as pottery, silk weaving, small-scale ship-building, and flatware (Calder, 1988: 319).

Table 5.9: The Growth of Government Loans to Japanese Small Business, 1970-1986 (Unit = Billion yen in loans outstanding)

Major Government Lenders to Big Business	1970	1975	1980	1986
Japan Development Bank	1905	3341	5018	7530
Export-Import Bank of Japan	1521	3217	5077	5444
Subtotal	3226	6558	10095	12974
Major Government Lenders to Small Business				
Central Cooperative Bank for Commerce and Industry[a]	1204	3431	5372	8599
Small Business Finance Corporation	895	2357	4350	5152
Peoples Finance Corporation	708	2036	4023	5284
Subtotal	2807	7824	13745	19035

Source: Calder, 1988: 320. Original source: Bank of Japan Research and Statistics Department (Tokyo: The Bank of Japan, various issues).
[a]Semigovernmental body.

In addition to these three major small business finance institutions, four other specialized bodies also assist small firms, including the Environmental Sanitation Business Finance Corporation, the Medical Care Facilities Corporation, and two regional finance institutions, the Hokkaidō-Tōhoku Development Corporation and the Okinawa Development Finance Corporation. They provide an additional $8 billion annually in specialized government loans at preferential interest rates (Calder, 1988: 318-20).

In addition to direct lending, the Japanese government also offers extensive credit guarantees to small businesses that borrow from private banks. “In 1981 the Small Business Credit Insurance Corporation had ¥5.155 trillion in insurance outstanding, including special insurance to encourage technology commercialization, equipment modernization, and introduction of the latest pollution control equipment into small firms” (Calder, 1988: 321).[86]

During the 70s, small business exercised growing political influence. The 1973 oil crisis and consequent stagflation hit small firms especially hard. Because farmers were a declining proportion of the national electorate, while small business was becoming more vocal and better organized and supporting the Japan Communist Party, the LDP became more aggressive in offering them attractive lending arrangements. Specifically, MITI's budget for loans to "very small enterprises" (five employees or fewer in manufacturing and two or fewer in retailing) was expanded dramatically from ¥30 billion to ¥240 billion in the early to mid 70s. Additionally, the Bureau for Small and Medium Enterprises within MITI was elevated in status to an agency and its budget increased from ¥7.5 billion (1971) to ¥40 billion (1975), and its share of the total MITI budget increased from 16 percent to 39 percent (Yamamura and Yasuba, 1987: 369).

As of the end of 1980, the private institutions catering to small firms, including the mutual loan and savings banks and credit associations, held ¥21.43 trillion and ¥26.35 trillion in loans and discounts respectively. The lending from private banks, in combination with the government loans amounting to ¥13.745 trillion, comprises a considerable fraction of total lending in Japan, as seen in table 5.1 (which excludes government lending). Indeed, as small firms have become more politically influential, their access to credit via government intermediaries and local lending facilities has improved considerably.

<u>Big Firms</u>

During the 50s and 60s, Japanese firms relied heavily on subsidized bank lending in order to become competitive in the global marketplace, particularly with respect to the

American market. The following table illustrates the reliance on lending up to the mid to late-70s, when securities markets started becoming more important.

Table 5.10: Sources of External Funds, Flow Data: 1956-1995
(Percentage Distribution)

	Securities Markets					Domestic Borrowing			Foreign Borrowing[b]
	Total	Equity	Domestic Bonds	Foreign Bonds	CP[a]	Total	Private Lender	Public Lender	
1956-1960	22.36	17.62	4.76	0	0	74.26	68.38	8.88	3.36
1961-1965	20.12	15.24	4.82	0.06	0	74.98	68.9	5.12	4.92
1966-1970	11.58	7.7	3.7	0.2	0	85.98	76.82	9.38	2.42
1971-1975	10.9	4.3	0.3	6.2	0	86.3	78.4	7.9	2.8
1976-1980	14.2	4.7	1.6	7.9	0	83	71.6	11.3	2.8
1981-1985	16.2	2.9	5.1	8.2	0	84.5	77.3	7.2	-0.6
1986-1990	28.1	3.8	8.9	9.7	5.8	66.2	58.9	7.3	5.7
1991-1995	20	20.4	0.8	4.2	-5.4	75.7	43	32.6	4.3

[a] CP is commercial paper.
[b] Foreign borrowing includes loans from both private and public institutions (such as the World Bank).
Source: Bank of Japan, Economic Statistics Quarterly, various issues. Hoshi and Kashyap, 2001.

The domestic borrowing figures, however, comprise lending for all firms. To get a better sense for the move toward securities markets by large firms, we can examine data for bank lending to small/medium sized firms as a proportion of total lending.

Table 5.11: Bank loans to small and medium sized firms, 1968-88

	Total loans (¥ trillion)	Loans to small/medium sized firms (¥ trillion)	(B/A) (%)
1968	28.8	9.6	33.4
1973	71.3	26.2	36.7
1978	118.1	49.2	41.6
1983	181.0	78.4	43.3
1988	288.2	153.0	53.1

Source: BOJ (annual). Also Horiuchi 1996, in Sheard 1996.

The clear increase in the proportion of total bank lending to small/medium sized firms indicates that large firms are increasing their reliance on securities issues to an even greater extent than table 5.10 suggests. Since large firms are the only actors that usually meet the eligibility requirements for financing from securities markets, in addition to being the main recipients of bank lending, their financing characteristics are highly important to determining the bank-market orientation of the overall financial system. To understand what motivated the changes in their financing structure over time, it is necessary to examine government policy.

On June 25, 1950, the U.S. declared war on Korea. With this, the US began to place extensive orders with Japanese firms for ammunition, trucks, uniforms, communications equipment, and other products.[87] This windfall, however, created financial difficulties for Japanese firms who could not obtain investment capital fast enough to meet the orders that the Americans were placing. Additionally, their working capital was frequently insufficient to keep them in business if even a few of their contracts involved delays in payment of six months or more. It ultimately led to the two-tiered structure of government-guaranteed city bank overloaning and newly created government-owned 'banks of last resort.' These latter institutions, particularly the Japan

Development Bank, became powerful institutions as a result of their decisions to make or refuse 'policy loans' (Johnson, 1982: 200).

During the capital shortage, government loans to city banks (the twelve national banks to which the Bank of Japan extends loan privileges) were increased, and they in turn distributed the funds to the industrialists who were clamoring for money to expand their facilities. This started the process of central bank 'overloaning' that led to the nexus between city banks and industry (Johnson, 1982: 202).

Overlending involved a group of enterprises borrowing from a bank well beyond any individual companies' capacity to repay, or often beyond their net worth, and the bank in turn overborrowing from the Bank of Japan. Since the central bank is the ultimate guarantor of the system, it gains complete and detailed control over the policies and lending decisions of its dependent 'private' banks. Additionally, the financial risks associated with high debt levels are reduced since the central bank acts as an implicit guarantor of the debt positions of major Japanese companies.

This system fostered the keiretsu as successors to the zaibatsu. A typical keiretsu included a big bank, several industrial firms, and a general trading company. The bank plays the critical role during expanding business conditions by supplying capital to the members, and the trading company plays the critical role during contracting business conditions by importing raw materials on credit and fiercely promoting exports of products that cannot be sold domestically.

The Export-Import Bank of Japan was created on December 15 1950 to deal with the lack of adequate banking facilities to handle longer-term loans than were commercially available for the export of capital goods. In April 1952, when the

Occupation ended, the government renamed it the Export-Import Bank of Japan and gave it the additional task of lending Japanese importers the funds they needed for advance payments for commodity imports approved by MITI (Johson, 1982: 208).

Of the six government banks established between 1949 and 1953 (plus two more from the prewar era), the most important for industrial policy was the Japan Development Bank (JDB), created in March 31, 1951, which was the successor to the Reconstruction Finance Bank.[88] The JDB was to provide long-term equipment loans to private enterprise when the commercial banks were unable to assume the risks involved. The bank was placed under the Ministry of Finance's administrative jurisdiction, but MITI exercised a predominant policy-making influence because it was given the duty of screening all loan applications and making annual estimates of the shortfall between available and needed capital (Johnson, 1982: 209).

With the end of the Occupation, the government amended the JDB's charter (July 1, 1952) giving it authority to issue its own bonds and lifting the loan ceilings that SCAP had imposed. At the same time the Ministry of Finance modified all of the statutes covering the postal savings accounts, combining them into one large investment pool name the Fiscal Investment and Loan Plan (FILP). This 'second' or 'investment' budget was constructed annually by officials of the Ministry of Finance. From 1953 on it became "the single most important financial instrument for Japan's economic development" (Johnson, 1982: 210).

From 1953 to 1961 the direct supply of capital by the government to industry (as opposed to its indirect supply via overloans) ranged from 38 percent to 19 percent. The JDB contributed 22 percent in 1953 and only 5 percent in 1961; although the size of its loans declined relative to the growth of city-bank funding, the bank retained its power to 'guide' capital through the indicative effect of its decisions to support or not support a new industry. A JDB loan, regardless of its size, became MITI's seal of approval on an enterprise, and "the company that had received a JDB loan could easily raise whatever else it needed from private resources" (Johnson, 1982: 210-11). As Okimoto (1989) illustrates, Japanese industrial policy assisted both extraordinarily efficient and inefficient sectors. Most of the latter sectors fell under the domain of the ministries of Agriculture, Fisheries, and Forestry, Construction, Health and Welfare, Transportation, Finance, and the Japan Defense Agency. Most of these catered to local interest group demands, as one would expect from the electoral incentives that politicians faced. The more efficient industries tended to be sponsored by MITI, though there were problems here as well, such as coal and textiles.[89]

These financial institutions served government needs for channeling funds into politically favored industries especially during the 1950s and 1960s.[90] "The [city] banks were the dominant providers of funds during 1955-75," consistently supplying over 60% of external funds acquired by the firms (Hoshi and Kashyap, 2001, ch. 6).[91] Funneling money through the banking system permitted the government to not only control the direction of funds, but also their cost.[92] Ueno summarizes the situation:

> Broadly speaking, the total supply of funds in Japan was controlled by the Bank of Japan, the level and structure of interest rates were artificially regulated by the Ministry of Finance, and private funds were allocated, under the guidance of public financial institutions, by city banks which competed for market shares. In this process, the Bank of Japan followed the guidelines of the Economic Planning Agency and the MITI and determined the total amount of funds so as to satisfy the demands to growth industries. At the same time, the Ministry of Finance maintained

> the low interest policy inasmuch as the policy did not lead to large deficits in the balance of payments or to sharp price rises.[93]

During the period 1952 to 1973, bond and equity markets suffered from regulations discouraging their use. Bond yields were generally kept lower than a market-clearing rate, deterring investors from buying bonds. Equity markets suffered from low levels of individual wealth following WWII, post-war inflation and land reform which wiped out most wealthy business families and landlords. Lack of legal protection for stockholders played a key role, and this was primarily due to the political interests in the legislature (i.e., big firms preferred subsidized bank lending, and since they would be the only interests in favor of securities markets, their lack of political support for markets led to banking-dominated finance). Moreover, interest payments on debt financing were deductible, offering a further disincentive to equity financing. Equity and Bond issues that did occur were subject to rationing according to government determined priorities.[94]

Because Japanese industrial policy stimulated overlending and overborrowing, there was vulnerability to downturns in the business cycle or to unexpected events such as the oil crisis. It is useful to examine the sequence of events to understand how and why large firms switched from relying on government subsidized loans to seeking financing on the Euromarkets in the mid to late-1970s.

Capital liberalization increased for Japan after becoming a member of the OECD in 1964. As part of joining the sixteen other members in this organization, Japan agreed to end restrictions on capital transactions and committed itself to trade liberalization. Membership would also allow Japan greater ease in floating securities in overseas markets, which was important to its growing involvement in Korea, Taiwan, Singapore, and much of East and Southeast Asia. Capital liberalization occurred slowly since domestic industry sought protection from foreign competition by restricting capital investment by foreign firms. Additionally, the low capitalization of Japanese firms, a consequence of the overlending and overborrowing conditions, made them easy targets for foreign acquisition. Nonetheless, export trade boomed in the late 60s and up to 1971. With Japan's greater vulnerability to the international economy, the devaluation of the dollar on August 15 1971 meant that Japan could not rely on the continuation of its balance of trade surplus with the United States. This caused business to slump, and led to the recession of 72-73. In response, the government increased its fiscal budget in 72 and 73 to stimulate business under the guidance of Tanaka's (the newly elected president in 1972) 'plan for rebuilding the Japanese archipelago'. Private enterprise was flush with excess capital as a result, which was invested in real estate, and ultimately created inflationary pressures. This was compounded by the oil shock in 1973, which forced Japan to go through a period of "crazy prices," and led to a severe deterioration in its balance of payments; what was once a considerable surplus over $7 billion in 1971, became a $1.1 billion deficit in November 1973 (Uchino, 1983).

Immediately, strict reductions in aggregate demand were pursued through restraints on fiscal spending by the government, on investment outlays by private industry, and on consumer spending. On December 22, interest rates were increased by 2 percent, raising the official discount rate to a postwar high of 9 percent. By 1975, the inflation was contained to below 10 percent, however, this process was accompanied by the deepest and the most prolonged recession in Japan's postwar history. In 1974, real GNP declined for the first time in the postwar period; economic growth during the lowest levels of the recessions in 1958 or 1965 bottomed out at 5 to 6 percent. There were large-scale declines in government investment and many firms were forced to liquidate in order to pay off outstanding debts; small and medium-sized firms were hardest hit. The government announced stimulatory fiscal and monetary policies in February, March, and June 1975, but these were not sufficient to stimulate a recovery (Uchino, 1983: 172-211).

The result for the financial system was that large firms had to look elsewhere for external financing, especially since their own internal reserves were quickly falling. Large firms were attracted to the Euromarkets which were flush with Eurodollars from OPEC countries. Firms increased their reliance on Euromarkets, which continued to be cheaper than domestic sources of finance, and because there was no collateral requirement, no mandatory prospectus, as well as a panoply of flexible rate instruments and swaps that reduced interest rate and exchange rate risks (Rosenbluth, 1989: 149). In the early 1970s the Euromarket accounted for a total of 1.7 percent of Japanese corporate financing; for the second half of the 1970s it was 19.6 percent. By 1984, the figure rose to 36.2 percent. Smaller firms, however, could not turn to the Euromarket since they did not pass the minimum capital requirements. This forced Japan to liberalize its domestic corporate bond market, and later, its equity market. Ultimately, Japanese city banks were forced to adopt new roles as market-makers and underwriters in order to retain the business of their large clients (see Rosenbluth, 1989). In the end, Japan was forced to bolster it securities markets in order to satisfy the financing demands of a critical political supporter—big business.

Conclusions

In the prewar period the political power of big business and large landowners dominated that of small business, small farmers (tenants), and labor. The oligarchs, who had close ties to big business, sustained an economic environment free from government interference as Japan industrialized. Since there were sufficient savings to meet financing demands and insufficient foreign competition to require infant industry policies in the form of subsidized lending, markets, rather than banks, became the primary source for external firm financing.

The war with China firmly pushed Japan toward a reliance on banking as the leaders concentrated and centralized the banking system to increase their control over it in order to direct funds toward the military-industrial complex. WWII deepened large firms' linkages with their 'assigned' banks. But, as seen in the US and UK, the temporary wartime reliance on banking does not necessarily lead to a banking-oriented financial system once the war has ended, making it important to examine the postwar political and economic environment.

Following WWII, capital scarcity forced the government to intervene in the allocation of available credit to basic heavy industries, using the same bank-firm relationships as during the war. Despite SCAP's intentions to break the power of the zaibatsu, economic exigencies largely allowed them to continue as before. The democratic reforms after the war gave far more political power to farmers and small firms than they had enjoyed in the pre-war years. Large firms also remained politically powerful while labor was stamped out as a result of U.S fears over the communist threat emerging in Japan. The structure of the post-war financial system reflects these actors' political power: total lending volumes and local credit facilities skyrocketed for small business and farmers. Large firms also prospered, receiving subsidized and directed lending until the government could no longer afford it once the oil crises and stagflation of the 70s hit. Large firms turned to Euromarkets for their external financing, but were attracted back to Japan's securities markets as the government made appropriate regulatory changes.

[1] Johnson, 1982: 84.
[2] Data calculated as demand deposits relative to securities (net).
[3] Wada, 1996, p. 7.
[4] Wada, 1996, p. 11.
[5] Sat-Cho is the abbreviation used by Japanese historians to designate the oligarchy of Satsuma and Choshu men who constituted the supreme governing power of Meiji Japan.
[6] For a very detailed discussion on prewar Japan's political institutions, see Scalapino, 1967. Also see Ramseyer and Rosenbluth, 1995, Matsunami 1979, Berger 1977, Duus 1968, Umegaki 1988, Banno 1992, Banno 1987, and Norman 2000.
[7] Scalapino, 84-87
[8] Ramseyer and Rosenbluth, 36.
[9] Scalapino, 151; Iwasaki, 33.
[10] Iwasaki, 33.
[11] In particular, the Diet's resistance to the oligarchs' fiscal policies prompted the oligarchs to adjust the electoral rules in 1900, doubling the electoral base to 983, 000 voters, or 2.2 percent of the population.[11] This was designed to introduce more urban voters and to pave the way for higher land taxes. Additionally, the new electoral rules established multi-member districts in place of the single-member districts to stymie the influence of parties (that is, multi-member districts would force candidates from the same party to compete with each other in the same district, thereby weakening party unity regarding electoral policy and strategy).[11] Another revision to the electoral system occurred in 1919, increasing the electorate to 8 million people, or over 5 percent of the population, to head off imminent calls for universal suffrage and to quell political unrest (the oligarchs knew that the Bolsheviks had engineered a coup and massacred the Romonovs, that the Prussian monarch William II had abdicated and fled to the Netherlands, and that the Japanese urban poor had been rioting en masse; Lewis, 1990). Single-member districts were also reintroduced, which fostered candidates' incentives to identify with a specific party. Multi-member districts with single nontransferable votes were reimplemented in 1925. The first election under these new rules occurred in 1928, and it formed the basis for Japan's postwar electoral system. See Fukui, Haruhiro, 1988, "Electoral Laws and the Japanese Party System," in Gail Lee Bernstein and Haruhiro Fukui, eds., Japan and the World. London: Macmillan, 119-43.
[12] Members of the bureaucracy were hand-picked by the oligarchy (Privy Council, Genrō, and House of Peers) until they changed the requirement to enter via a civil service exam, which simply changed it from an aristocratic clique to a university clique (Iwasaki, 1920: 53). The cabinet ministers ran various departments of the bureaucracy, and the bureaucracy was responsible for implementing the laws.
[13] See, for example, Berger 1977.
[14] For more detail and clear explanation of the prewar government, see Kōichi, 1988, *Politics in Modern Japan.*
[15] To control inflation, for example, Matsukata Masayoshi, the minister of finance, issued his famous "Outline Regulations for the Sale of Government-Operated Factories."
[16] Scalapino, 251.

[17] See Morikawa, 1992. Regarding the Meiji era, Iwasaki remarks, "The way to get rich was to become the friend of some high officers in the government. Such friendships were frequent. For example, Marquis Inouye, the great Genrō and leader of financial reform, was an intimate of the Mitsui family. Marquis Okuma and the Iwasaki family, the steamship kings, are also closely associated. *The connection between the government and big business in Japan is frankly admitted*" (italics mine); Iwasaki, 1920: 102.
[18] See Allen, 1981, *A Short Economic History of Modern Japan*, chapter 8.
[19] Umegaki, 1988.
[20] Scalapino, 263.
[21] Scalapino, 265.
[22] Ramseyer and Rosenbluth, 45
[23] Soma, 1986: 41-42.
[24] See, for example, Sasahiro, 1932: 42 and Furushima 1951:165-68.
[25] See Duus, 1968: 19-24, and Ramseyer and Rosenbluth, 52.
[26] Hazama, 1997. Also see Colegrove (1957: 402).
[27] For information on business elites' preference for capitalism (but not with regard to bank or securities markets), see Marshall, 1967, *Capitalism and Nationalism in Prewar Japan*. For a thorough account of Japan's prewar financial system, including the formation of securities markets, see Adams, 1964, *A Financial History of Modern Japan*.
[28] See Adams, 1964 , chapters 1, 2, 3, and 4; and Hoshi and Kashyap, 2001, chapter 2.
[29] See Adams, 1964, chapter 3 and Hoshi and Kashyap, 2001, chapter 2.
[30] Hoshi and Kashyap, 2001, chapter 2, p.12.
[31] This type of control was actually espoused by the right-wing of the workers' movement. The more leftist elements did not raise comparable demands likely because they feared harsh penalties from the government, who cracked down very hard on labor in 1928. See Totten, 1966: 242. For more on Japan's prewar Communist Party ideology, see Hoston, 1986.
[32] See Totten, 1966: 244. The proposal is quoted in full in Nihon Rōdō Nenkan, 15 (1934), 436-38.
[33] See Garon, 1987.
[34] Garon, 1987: 168.
[35] Garon, 1987: 184.
[36] Garon, 1987: 169-70.
[37] Ramseyer and Rosenbluth, 104; and Ginkō tsūshin roku, 79: 6 (June 28, 1892).
[38] Ginkō gappei hō [Bank Merger Act], Law No. 85 of April 1896. See Kin'yu kenkyūkai (1932: 13).
[39] See data in Ramseyer and Rosenbluth on the number of small banks over time. Original sources: Bank of Japan, Honpō keizai tōkei [Economic Statistics of Japan] (Tokyo: Bank of Japan, 1935), pp. 6-39; Shin'ichi Gotō, Honpō ginkō gōdōshi [History of Bank Mergers in Japan] (Tokyo: Kin'yu zaisei jijō kenkyūkai, 1973), pp. 55, 93, 127, 211, 359, and 377.
[40] Kazuo Ueda, 1999, 39-40. Ramseyer and Rosenbluth, 110.
[41] The law gave banks five years to meet the new capital requirements, but many banks were unable to do it despite efforts by Seiyūkai members to help banks raise the capital.

[42] Ramseyer and Rosenbluth, 113; and Sumitomo, ed., 1979: 250.
[43] Ramseyer and Rosenbluth, 114; and Zenkoku, 1988: 54-55.
[44] Lockwood 1954, 289.
[45] See Adams, 1964, pp. 128-59 and Hoshi and Kashyap, 2001, ch. 3 p. 2.
[46] ibid.
[47] ibid.
[48] ibid.
[49] See Cohen, 1949: 95; Adams, 1964, pp. 128-59; and Hoshi and Kashyap, ch. 3, p. 4.
[50] See Adams, 1964, pp. 128-59; and Hoshi and Kashyap, ch. 3, p. 2.
[51] See Adams, 1964, pp. 128-59; and Hoshi and Kashyap, ch. 3, p. 3.
[52] See Adams, 1964, pp. 128-59; and Hoshi and Kashyap, ch. 3, p. 5.
[53] see Hoshi and Kashyap, ch. 3, p. 17 for an example for Toyota and Mitsui Bank, as well a Miyajima 1994, p. 311 for several more examples.
[54] Hoshi and Kashyap, ch. 3, pp. 14-5.
[55] Hoshi and Kashyap, ch. 3, p. 12.
[56] Sheingate, 90
[57] Mulgan, 43.
[58] Sheingate, 151. Dore, Land Reform in Japan, 131-32. Morris-Suzuki et. al. Japanese Capitalism since 1945, 1989, 88-89.
[59] Fukutake, *Japanese Rural Society*, 181.
[60] SCAP, Natural Resources Section, *Agricultural Programs in Japan*, 1945-51, 1952, 37; Junnosuke, *Postwar Politics in Japan*, 258-59.
[61] Mulgan, 2000: 49. Also, see Mitsukawa, Nogyo Dantai Hattenshi, p. 132. Calder gives different figures: from 892 in March 1948 to 27, 819 by the end of the year. Crisis and Compensation, p. 252.
[62] Mulgan, 2000: 50. For a detailed description of each of the businesses of the agricultural cooperatives, see Zenkoku Nogyo Kyodo Kumiai Chuokai, *Shinpan: Nogyo Kyodo Kumiaiho*, pp. 66-113.
[63] SCAP, *Agricultural Programs in Japan*, 1945-51, 114-16; Dore, *Land Reform in Japan*, 282-87; Sheingate, *The Rise of the Agricultural Welfare State*, 153.
[64] Masumi, Postwar Politics in Japan, 259.
[65] Dore, Land Reform in Japan, 415.
[66] also see Mulgan, 2000.
[67] Hoshi and Kashyap, ch. 3, pp. 8-10.
[68] Hoshi and Kashyap, ch. 3, p. 8.
[69] Hoshi and Kashyap, ch. 3, pp. 8-9.
[70] Yamamura 1967, 27-8.
[71] Yamamura, 1967, 28.
[72] Broadbridge 1966, 32-3.
[73] Hoshi and Kashyap 2001, ch. 3.
[74] Originally from *Nippon Keizai Shimbun*, September 1, 1947; *Shakai Shimbun*, September 1 and 6, 1947.
[75] See Colebert, 90. Originally from *Yomiuri Shimbun*, February 19, 1947; Jiji Press release, January 12, 1948; *Mainichi Shimbun*, January 13, 1948.

[76] Cowhey and McCubbins, 1995, 37-8
[77] See Sakakibara, 1993, pp. 29-66 and Okimoto, 1989.
[78] In the 70s and 80s it has increasingly sought urban customers.
[79] Calder, 1988: 262. Originally from Imamura Naraomi, *Hojokin to Nōgyō Nōson*, p. 76.
[80] Calder, 1988: 236. Many of these Dietmen come from districts with only a small number of full-time farmers. But Japan has an extraordinary number of part-time farmers.
[81] Patrick and Rohlen, 1987, in Yamamura and Yasuba (eds.) *The Political Economy of Japan.*
[82] Although city banks started targeting small firms in the 80s; see Horiuchi 1996.
[83] See Hugh T. Patrick, "Cyclical Instability and Fiscal-Monetary Policy in Postwar Japan," in State and Economic Enterprise in Japan, William W. Lockwood, ed.
[84] Calder, 1988: 321-2. For details, see Nihon Ginkō Kyōkai Ni Jyū Nen Henshū Shitsu, ed., *Ginkō Kyōkai Ni Jyū Nen Shi* (Bankers Association Twenty Year History).
[85] For details, see Kent E. Calder, "Politics and the Market," appendix 1 in Crisis and Compensation.
[86] Japan Small Business Corporation, Outline of Small and Medium-Sale Enterprise Policies of the Japanese Government, p. 70. Also see Calder, 1988: 321.
[87] See Supreme Commander for the Allied Powers, Monograph 47, "The Heavy Industries," p. 120.
[88] The eight government banks existing at the end of 1953 were the Central Cooperative Bank for Agriculture and Forestry (1926), the Bank for Commerce and Industrial Cooperatives (1936), the People's Finance Corporation (1949), the Housing Loan Corporation (1950), the Export-Import Bank (1950), the Japan Development Bank (1951), the Agriculture, Forestry, and Fishery Finance Corporation (1953), and the Smaller Business Finance Corporation (1953).
[89] Okimoto, 1989, 5.
[90] For more on the relationship of banks with industry during the century, see Ogura, 2002, Banking, the State and Industrial Promotion in Developing Japan. For more on specific goals of government industrial policy during the postwar period, see Komiya, Okuno, Suzumura, 1988, Industrial Policy of Japan.
[91] Also, mergers took off in 60s (like France), see Halliday, 1978, 278.
[92] The Temporary Interest Rate Law (1947) regulated the level of interest rates attached to bank deposits and short-term bank loans.
[93] Hiroya Ueno, "The Conception and Evolution of Japanese Industrial Policy," in Sato, Industry and Business in Japan.
[94] see Hoshi and Kashyap, 2001, Ch. 4, p. 6.

Chapter 6

Conclusions

What explains varieties of capitalism? I have sought to explain why some countries are closer to the liberal market economies pole (in which markets prevail), while others are nearer the coordinated market economies pole (in which non-market mechanisms dominate) by asking and answering the narrower question: What explains the bank-market orientation of national financial systems?

My main argument is that the structure of national financial systems depends on the political power of large firms, who usually prefer markets, relative to the political power of labor, farmers, and small firms, who usually prefer banks. Both quantitative and qualitative evidence strongly support it. In chapter two, I broke this core argument down into a series of hypotheses and corollaries. Here, I discuss the evidence for each one in turn

Evaluating the Hypotheses

H1: Large firms are more likely to receive subsidized lending via banks when: (1) large firms are uncompetitive in their main foreign markets; and (2) international trade and capital flows are low.

The empirical evidence supporting this hypothesis is based solely on the case studies since it is difficult to get cross-national data of this sort during the 1950s and 60s. Both case studies, however, support this hypothesis. From 1944 to the 1970s, large firms in France first received subsidized lending in order to rebuild basic industries following the war. They continued to receive favored lending arrangements so that they would be competitive in the European marketplace when the Rome Treaty in 1958 began liberalizing trade. De Gaulle pushed for mergers among France's largest companies, and offered them privileged access to financing in order to create 'national champions' that could compete in the global arena against American and other large European companies.

Japanese firms went through a similar process. At first, heavy industries received privileged lending arrangements during the Occupation, and then firms in favored export sectors enjoyed below-market financing to make them competitive with firms in the American market. Indeed, directing subsidized lending to industries considered to have potential and exhibiting fast growth rates was part of Japan's development policy during its high-growth era.

If we relax either of the two conditions, have we witnessed firms receiving subsidized lending? First, let us relax the second condition: have large firms received subsidized loans when international trade and capital flows are high? Large firms that are considered national priorities will receive subsidized lending when international trade and capital flows are high, such as aerospace or defense-related enterprises—we see this in France during the 1980s. However, it is unlikely that a large proportion of total firm financing will be subsidized; these firms are likely to be the exception to the rule. On average, large firms are less likely to receive subsidized lending when international trade and capital flows are high. Since openness in industrialized nations is, to a considerable degree, determined by large firms, these firms must be competitive in foreign markets for the country to have high international trade and capital flows. In this regard, it is more important to determine whether the enterprises are competitive in foreign markets; that is, the first condition is the more important of the two conditions in the hypothesis and to a large extent determines the second condition. But since international trade and capital flows are not determined entirely by domestic interests, it is necessary to include the second condition.

Second, let us relax the first condition: do competitive firms receive subsidized lending when international trade and capital flows are low? In such cases, the international trade that large firms engage in comprises a small fraction of the nation's economy. This was the case, for example, in pre-1914 Japan, and has been the case for the United States during the twentieth century. In these examples, large firms have been competitive in their main foreign markets, and therefore do not require subsidized lending. Although firms seek cheap financing, there are costs that come with subsidized bank lending, which may compromise firms' profitability and competitiveness (e.g., loss of autonomy, less powerful incentive-based pay schemes). Whether owners and managers benefit personally to a greater degree with markets than with bank lending is worth examination in future work.

Thus, both conditions are necessary, with the first condition being more important: firms are more likely to receive subsidized lending via banks when they are uncompetitive in their main foreign markets. Both case studies support this hypothesis, but additional cases and/or a data set would add confidence to these results.

H2: Increasing international trade and capital flows bolster national securities markets via mechanisms that are external *and* internal to the firm.

This hypothesis is also tested exclusively with the case studies since operationalizing regulations affecting both corporate governance and securities markets across many countries would be excessively time consuming. Time would be better spent evaluating the core argument - H6. With regard to the external component of the hypothesis, the statistical analysis extends Rajan and Zingales's tests across decade intervals by finding that higher levels of international trade and capital flows correlate with an increasing reliance on securities markets on an annual basis. Since the work done by Rajan and Zingales focuses on external mechanisms that bolster the reliance on securities markets (balance-of-payments equilibrium and associated macroeconomic policies), I will turn to the internal side of the hypothesis.

In France, the first important change in corporate governance rules occurred in 1867, with the rule permitting the formation of Sociétés Anonymes without the consent of government, as well as the corporate form of business organization (i.e., limited liability with a board of directors and shareholders able to influence management). Following free trade agreements with Britain and Belgium, French firms faced increasing competition from foreign enterprises that could raise capital more easily on their domestic securities exchanges. To compete, these new corporate governance laws sought to prevent French firms from going to England and Belgium to raise capital, and to instead seek financing domestically. This case supports the internal side of the hypothesis, but these new regulations were only possible because of the greatly increasing political influence of newly emerging industrial enterprises. International pressure caused the change only because domestic politics were conducive to it.

In 1966 and 1967, two new laws were passed regarding corporate governance. The first law offered the possibility of organizing the société anonyme on the German model, (i.e., with a directorate and a supervisory board instead of the board of directors of

1867). The second innovation was the institution in 1967 of 'economic groupings' designed to promote the creation of bodies common to several companies (Caron, 1979: 281). This second law essentially permitted the concentration of large firms in accordance with de Gaulle's vision of having national enterprises competing in the international marketplace. Indeed, Caron remarks that, "the last years of the 1960s were dominated by the more rapid growth of large enterprises. There is also an acceleration in the tendency toward mergers…"(Caron, 1979: 292). Both of these laws arose out of France's desire to effectively compete in an increasingly competitive European marketplace. At this time, the UDR (Gaullists) controlled the government, and so domestic politics were again critical to the creation of these new rules that were motivated by growing international pressure. However, neither rule created governance structures that privileged market financing – in fact, banks were even more heavily relied upon to direct funds to France's largest enterprises.

In Japan, corporate governance rules were put in place following WWII, and resemble those of the United States as a result of the influence of Occupation forces.[1] Japanese boards of directors are very large, making them fairly ineffective, and thereby allowing the CEO considerable power. At this time, international trade and capital flows were very low, and had minimal influence on the corporate governance rules. These rules have not changed as international trade and capital flows have increased. Thus, Japan does not offer evidence for the hypothesis.

The cases offer weak support for the hypothesis that increasing international trade and capital flows cause alterations in corporate governance rules which ultimately favor market-oriented financing. However, it should also be pointed out that there are multiple mechanisms for the government to alter incentives for firms to use bank or market financing. If corporate governance rules cannot be modified, then other avenues may be pursued that achieve the same ends. Thus, the key point is that there are multiple methods, both internal and external to the firm, for altering the balance between market and non-market financing.

H3a: Higher levels of labor political power will lead to more banking-oriented financial systems.

This hypothesis is strongly supported with the statistical analysis and the France case study, using left-wing political power as a proxy for labor political power. The quantitative evidence illustrated a strong correlation (significant at the 1% level) between left-wing political power and the bank-market orientation of national financial systems for the 1976-1990 period. Additionally, there was a strong correlation in 1970. Examination of the trend between left-wing political power and the bank-market ratio across the twentieth century in France revealed a strong correlation too. Closer inspection of key points in time when left-wing political power peaked (1944-46 and 1981-82) showed that high levels of left-wing political power *cause* a greater reliance on banks. Because labor never gained much of a foothold in Japanese politics, they never had the opportunity to enact legislation affecting the structure of the financial system. Their main influence was indirect – via corporate governance laws, as Roe argues. As we saw, however, Japan was banking-oriented following WWII because of the need to offer subsidized lending to uncompetitive large firms. Employment stability could simply have been a by-product of the long-term nature of banking-oriented finance (e.g., Aoki, 1994).

H3a': Countries with proportional representation electoral systems will have higher labor political power, and will therefore be more banking-oriented.

This corollary was primarily evaluated with the cross-national quantitative evidence. It was clear from the evidence in chapter three that countries with proportional representation electoral systems tend to be more banking-oriented when left-wing political power is plotted against the bank-market orientation of national financial systems. France had a proportional representation system only very briefly immediately after WWII and in 1986. Japan experimented with proportional representation in the 1920s, but labor had negligible political power at this early date since they comprised a small fraction of the population and the lower house of the Diet had little political power, making it difficult to determine whether changes in the electoral system had any effect on labor's ability to alter the structure of the financial system. Other analyses have pointed to the beneficial effects of proportional representation for labor representation (e.g., Katzenstein, 1985), thus, the more important objective for this analysis is establishing the link between higher labor political power and more banking-oriented finance, as in hypothesis H3a.

H3b: Higher levels of labor bargaining power will lead to more banking-oriented financial systems.

This hypothesis received support from the statistical analysis, but not from the case studies. The statistical analysis found a strong correlation between labor bargaining power and nations' bank-market orientation across all 14 countries in the sample. Examination of the subset of countries with proportional representation electoral systems suggested that labor bargaining power has a stronger relationship for countries with plurality electoral systems (Canada, the US, UK, and France). In France, however, labor unions are quite weak in comparison to their political party counterparts; France is unique in this regard. Moreover, investigation of the historical evidence suggests that firms were forced to rely on banks because of government legislation, not because of labor bargaining power.

Given these findings, it would be worthwhile to perform a closer investigation of labor bargaining and firm financing in countries with Anglo-Saxon origins since the correlation observed in the statistical analysis is likely driven primarily by these countries.

H4a: Increasing farmer political power will lead to a more banking-oriented financial system.

The quantitative evidence demonstrates that there is a correlation between higher levels of farmer political power and a more banking-oriented financial system without controlling for other variables. When adding other variables, however, this relationship becomes insignificant. The case studies for both France and Japan illustrate that the level of banking finance directed to farmers corresponds to their political power. For example, prior to WWII, only large landowners wielded any real political power in both countries, and rural credit facilities existed that catered exclusively to this group; peasants and tenant farmers were neglected. After WWII, small farmers acquired far greater political representation, and banking facilities and finance directed to the rural sector flourished. Even with dramatically higher levels of agricultural lending, these intermediaries still had a small impact on the bank-market orientation of the overall financial system.

H4a': Countries with more malapportionment will have more banking facilities for farmers.

This hypothesis, like the one regarding proportional representation electoral systems and labor political power, simply asserts that an institutional mechanism which increases farmers' political power will increase banking services for farmers. Thus, it is more important to establish the link between farmers' political power and banking. Examination of the evidence for France and Japan, however, suggests that farmers enjoy more political power when there is greater malapportionment, if the political institutions are truly 'democratic' (that is, the oligarchy or the elite interests cannot block political initiatives of the lower house as in Third Republic France or in Japan's Meiji Constitution government). Thus, in postwar France and Japan, malapportionment magnified farmers' political power, and thereby helped them achieve their policy objectives, such as rural financing facilities. Indeed, farmers enjoyed unusually high levels of political power in France and Japan in comparison to other developed nations, which ultimately led to two of the world's largest intermediaries in the postwar period: the Crédit Agricole in France and the postal savings bank in Japan.

H4b: Higher levels of agriculture's contribution to the GDP will correlate with more banking-oriented financial systems.

This hypothesis can be rejected. Neither the statistical analysis nor the case studies suggest that banking facilities have any correlation with agriculture's contribution to the GDP.

H5a: Increasing small firm political power will lead to a more banking-oriented financial system.

Because it is very difficult to get a reasonable measure across countries for the political power of small firms, it is necessary to examine the validity of this hypothesis with the case studies. Both cases suggest that small firms received more financing after WWII because of changes in the political institutions of these two countries. In Japan, their political power was greater, and so it appears that they received a greater proportion of total banking finance. Small firms' political power increased during the 70s in each country: in France, the right-wing held onto a slim majority and sought the votes of small business owners by increasing available credit to them; in Japan, the LDP's rural vote was declining and so they sought small firm votes to compensate for this loss, and likewise increased bank lending directed to them. Like rural finance, however, the total volume of bank loans to small firms relative to the volume of credit in the overall financial system is so small that it makes a small difference in a country's bank-market orientation.

H5b: Higher proportions of the GDP deriving from small firms will correlate with a more banking-oriented financial system.

As with the hypothesis concerning agriculture's contribution to the national economy, this hypothesis regarding small firms is unsupported by the evidence. A greater proportion of the national economy depended on small firms in the pre-1914 years, yet both countries relied heavily on securities markets. What matters more is their political power.

H6: The combination of labor, farmer, and small firm political power will have a stronger correlation with banking-dominance than the political power of each group alone.

This is the core argument of the dissertation, and, fortunately, it has the strongest empirical support. Because of the difficulty of creating a measure for small firm political power, I only combine the political power of farmers and labor for the statistical analysis. In each test – the 1976-1990 period and the individual year tests for 1950, 1960, and 1970 – the combination of rural and left-wing political power is strongly significant in each case except for 1950, when it is only weakly significant (at the 10% level).

The case studies also support this hypothesis. Since there is strong evidence that higher levels of political power for each one of these actors leads to greater levels of financing directed through banks, the combination of these actors' political power should necessarily witness commensurately greater levels of lending via banks.

An interesting question is whether a coalition will form among these actors to direct more financing via banks generally speaking. There is only one example of this from both cases – the Popular Front and the Bank of France. During the Third Republic, the Bank of France was involved in lending to both small and large firms, and handled the transfer of funds to rural banks by the government. Thus, it was involved in credit allocation for each of the main actors, and for this reason, each actor wanted to alter its lending practices, except for large firms who wanted to maintain the status quo. No other institution has so dominated the national banking system in France or Japan.

Other coalitions have formed among these actors as well: small firms and farmers sought more local banking facilities in postwar Japan; and, large firms and employees of large firms were both in favor of de Gaulle's subsidized lending to create 'national champions'. Usually, however, each actor seeks specific banking facilities that service its particular financing needs. Consequently, coalitions for enhancing banking services are not as common as one might expect.

Additional Findings

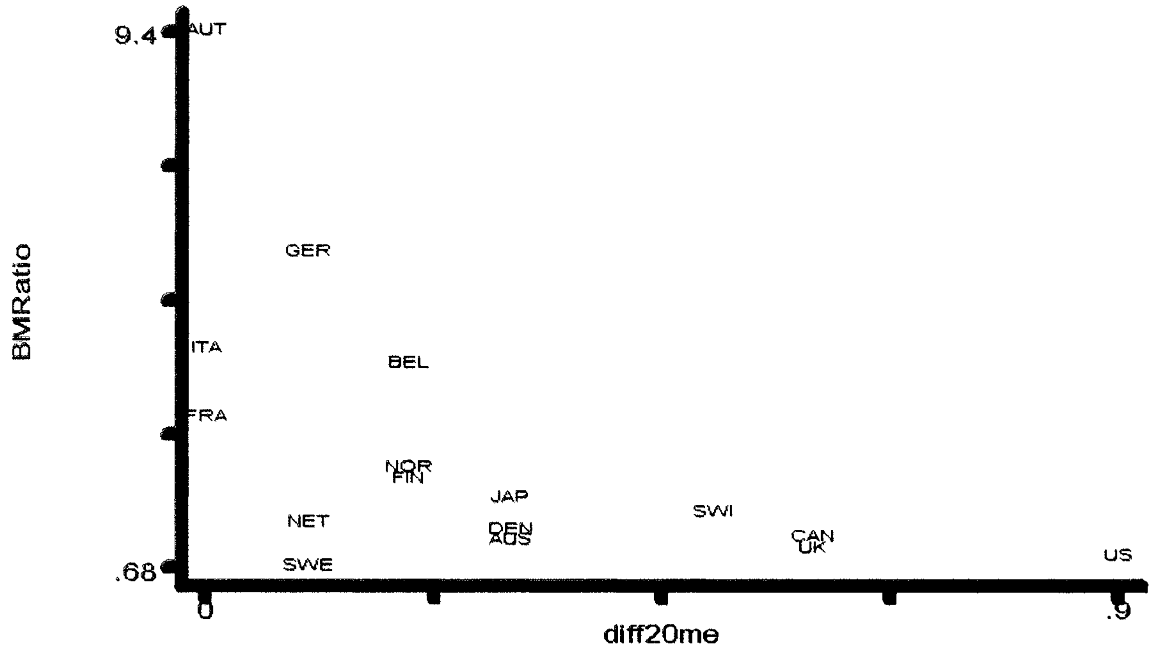
Domestic politics has a greater influence on the structure of national financial systems than international trade and capital flows. On the one hand, this is true since trade and capital mobility are partly determined by domestic interests. On the other hand, even when trade and capital mobility exert considerable influence, domestic political interests retain their predominant position. The statistical analysis reveals that in times of high and low international trade and capital flows, countries remain oriented according to the political power of labor and farmers; high levels of trade and capital simply constrain the spread, pushing all countries closer to the market end of the spectrum.

The case studies likewise reveal the importance of domestic interests for the pre-1914 era. During this period, large firms had a near monopoly in terms of their ability to politically influence the orientation of the financial system; large landowners were the only real competitors but their financing demands were swamped by those of industry. Indeed, Japan's low levels of trade matched with its reliance on securities markets illustrates that domestic interests played the crucial role.

But perhaps one of the most important findings is that large firms, relative to small firms and farmers, play such a dominant role in determining the bank-market orientation of the overall financial system. If they are competitive with foreign firms, they prefer markets generally speaking. If they are not competitive, they prefer subsidized bank lending. The extent to which labor can influence how financing is made to these firms, whether in the form of bank lending or equity and bond sales, is also of critical importance. Thus, the next step for understanding how countries are arrayed between the liberal market economies pole and coordinated market economies pole is to examine the political interplay of interests with a stake in corporate governance structures (labor, managers, and owners), and the consequences for firm finance (among other spheres such as employment protection).

Implications for Political Economy and Finance

One avenue of research into politics, corporate governance, and firm financing that would be of current interest would involve examination of how labor affects financing choices in an environment of high capital mobility, when securities markets heavily dominate firm financing. That is, does labor retain any influence on firm financing decisions? Looking at a simple correlation between the diffusion of corporate ownership in 1995 and the bank-market orientation of financial systems in 1995 (figure 6.1) yields a fairly strong correlation, where countries with more diffuse corporate ownership (e.g. US, UK) also have more market-oriented financial systems. This is not terribly surprising since Roe argues that increasing left-wing political power leads to more blockholding (i.e., less separation of ownership), usually by banks, and since I argue that increasing left-wing political power leads to more banking-oriented financial systems. But, the crucial question is whether blockholding was promoted *after* market-enhancing regulations were enacted by the government. This would involve time-series analysis, and would require further development of the corporative governance dataset currently available from LLSV (1998). A brief look at the trend in bank ownership of firm equity in Germany illustrates the expected correlation (see table 6.2).



Note: Austria = AUT, Australia = AUS

Figure 6.1: Bank-Market Orientation and Separation of Ownership

Table 6.1: Bank-Market Orientation and Separation of Ownership

DV: Bank Assets/Stock Market Cap.

Separation of Ownership[a]	-4.98** (-2.487)
constant	3.98
N	16
Adj. R-squared	0.25

Note: t-statistic in parentheses
** significant at the 5% level.
[a] Ownership separation for medium-sized public firms. If the firm had a blockholder owning more 20% or more of the firm's stock, it was classified as not fully public. Originally from La Porta, Lopez-de-Silanes, and Shleifer, 'Corporate Ownership Around the World, 54 J. Fin. 471, 492 (1999). The data principally come from 1995.

Table 6.2. Ownership of assets arising from shares in Germany, 1960, 1970, and 1988, %

	1960	1970	1988
Households	28.1	29.8	21.1
Non-financial enterprises	35.7	36.9	43
Banks	7	7.6	10.4
Insurance enterprises[a]	3.6	4	8.8
Government	13.6	9.3	4.6
Foreigners	12	12.4	12.1
Total	100	100	100

Note: [a] Including private pension funds and building and loan associations.
Source: Deutsche Bundesbank (1990). Also see Edwards and Fischer, 1994: 182.

As mentioned in chapter two, it would also be worthwhile to examine how financing choices vary across sectors of firms (e.g., high-tech versus low-tech, or specific industries), and whether there is a clear correlation between the political power of various sectors and the kind of financing arrangements that are privileged across national financial systems. Marrying Michael Porter's (1990) work in *The Competitive Advantage of Nations* with the work here could be especially fruitful.

Also of great interest are the implications for developing countries. Once these countries move beyond ISI and EOI policies which direct subsidized financing to favored industries, we can predict the likely structure of their financial system going into the future. This will permit national policymakers to consider whether the costs and benefits of a more market or bank-based financial system are something that they wish to embrace or to avoid, and to adopt appropriate policies.

A final question regards the implications for the nature of technological innovation? As market-finance becomes adopted more widely, does this place pressure on firms to adopt shorter-term earnings horizons as they seek to please institutional investors. As a consequence, will this lead to fewer companies involved in long-term, incremental innovation?

These are just a few of the many possible avenues for future research.

[1] See Allen and Gale, 2001 and Roe, 2002.

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