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Vedoucí bakalářské práce: doc. RNDr. Pavel Strnad, CSc.

Konzultant: Dr. Ali Al-Shamali

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doc. RNDr. Pavel Strnad, CSc.
vedoucí katedry

prof. Ing. Jiří Kraft, CSc.
děkan Hospodářské fakulty

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FACULTY OF ECONOMICS



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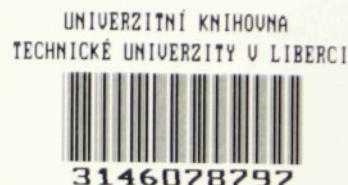
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Younes Mohamed Mouni



Supervisor: Doc. RNDr.Pavel Strnad, , CSc

Consultant: DOC.RNDr PAVEL STRNAD,CS ,DOC.Ali Al-Shamali

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I declare that this Bachelor work has been done independent with using some literatures and Knowledge of Supervisor and Consultation.

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1 INTRODUCTION OF USA

The US has the largest and most technologically powerful economy in the world, with a per capital GDP of \$37,600. In this market-oriented economy, private individuals and business firms make most of the decisions, and the federal and state governments buy needed goods and services predominantly in the private marketplace. US business firms enjoy considerably greater flexibility than their counterparts in Western Europe and Japan in decisions to expand capital plant, lay off surplus workers, and develop new products. At the same time, they face higher barriers to entry in their rivals' home markets than the barriers to entry of foreign firms in US markets. US firms are at or near the forefront in technological advances, especially in computers and in medical, aerospace, and military equipment, although their advantage has narrowed since the end of World War II. The onrush of technology largely explains the gradual development of a "two-tier labor market" in which those at the bottom lack the education and the professional/technical skills of those at the top and, more and more, fail to get comparable pay raises, health insurance coverage, and other benefits. Since 1975, practically all the gains in household income have gone to the top 20% of households. The years 1994-2000 witnessed solid increases in real output, low inflation rates, and a drop in unemployment to below 5%. The year 2001 saw the end of boom psychology and performance, with output increasing only 0.3% and unemployment and business failures rising substantially. The response to the terrorist attacks of 11 September 2001 showed the remarkable resilience of the economy. Moderate recovery took place in 2002, with the GDP growth rate rising to 2.45%. A major short-term problem in first half 2002 was a sharp decline in the stock market, fueled in part by the exposure of dubious accounting practices in some major corporations. The war in March/April 2003 between a US-led coalition and Iraq shifted resources to military industries and introduced uncertainties about investment and employment in other sectors of the economy. Long-term problems include inadequate investment in economic infrastructure, rapidly rising medical and pension costs of an aging population, sizable trade deficits, and stagnation of family income in the lower economic groups.



2 USA MARKET

The United States with a total area of 9,809,386 sq. km is about two and one-half times the size of Western Europe. With a population of 272,639,608 (July 1999.), the USA is home to approximately 4 per cent of the world's population. The country with its wealth of natural resources, integrated and largely self-contained economy, political stability and free market system has the most powerful, diverse, and technologically advanced economy in the world. The economy is marked by steady growth (at 2 per cent per annum), low unemployment and low inflation (1 per cent). Its consumer population enjoys a high standard of living, with GDP at \$31,500 per capita (1999). International trade's share of the United States' GDP is approximately 30%.

The work force numbers 137.7 million of which 72 per cent are engaged in professional, managerial, technical and service industries. The unemployment rate is 4.5% (1998).

Politically, the United States is divided into 50 states and District of Columbia. Federal or national laws apply throughout the entire USA. Individual states have a good deal of autonomy, running their own legislatures, administration and judiciaries



The US is one of Britain's largest markets and a leading destination for British overseas investment with the value of UK goods and services exported totaling £44.9 billion (1998) and investments amounting to \$129.5 billion (1997). Few limitations face British firms seeking to do business in the US. The telecommunications, software, food and drink, giftware, and environmental markets are currently favorable opportunities for British exporters. Foreign investors are generally treated on an equal footing with



domestic businesses. There are no restrictions on moving capital in or out of the US (or between States) or on the repatriation of profits.

Owing to the size and diversity of the USA, it is prudent to treat the country as a series of regional markets, each with their own varying characteristics.

The US is a particularly attractive market to UK exporters and investors. Americans appreciate the long-standing bonds of friendship and common cultural linkages and common language. For experienced and first-time exporters, the old adage 'Go west, young man' is apposite, as more and more opportunities are opened by this strong, prosperous and receptive market.

3 International Business Culture, Language, and

Practices

- Cultural and language issues and answers
- Booths and freight
- Possible impacts of commercial laws in host countries

3.1 *Cultural and Language Issues and Answers*

People talk about the USA as a melting pot. That implies an amalgam, a homogeneous blend. Though less dramatic, it is more accurate to describe the nation as a mixing bowl filled with wheat, rice, corn, and spices. There is a strong flavor of shared ideals and values. However, each group retains its own, too.

3.2 *The Global Show Redaction*

Global show is a smaller-scale version of the maxim bowl. Deluge:

The International Scene and exhibitors come from different nations, religions, languages, traditions-there are many differences. However, there are also those underlying threads of shared knowledge, interests, and ambitions. A pleasant plus is that one is not expected to be an expert on all the nuances of culture, language, and even business practice within all the nations represented. You should know perhaps a little,



especially about what is proper in the host country. (That has to do with getting around town more than booth behavior.) However, there are two guidelines that will see you through, regardless of what you know or do not know.

- **Be Polite and Formal.** A bit of restraint is always wise when meeting new people. That is especially the case at global shows. Do not assume you know the traditions of the country. In the USA, for instance, people start using first names with each other quickly. Chinese culture is much more formal.
- **Do Not Impose.** People from the United States are getting better about not imposing their own values on others. However, there is a long history of "the Ugly American" to overcome. It is a global reputation, and when cited, it means only people from the USA, not those from other American nations. Perhaps fueled by vastly improved global communications, the Ugly Americans have been learning, rapidly, how to be better guests in other lands and how to be better hosts as well. Each booth in the global village is a home. Be polite, stick to business, and do not try to impose your ways on others. Guests and visitors will be flexible, too.
 - **Names.** At USA domestic shows, where a relatively higher degree of informality is acceptable, business cards are exchanged with hardly a glance. Worse than that, little effort is made by either delegates or booth staff people to remember more than each other's first names. This practice, too, is changing as booth staff people awaken to the reality that they do better after they focus more on the person they are talking to.
 - **Business Cards.** At international events, or in-country shows outside' the USA and Canada, considerably more attention is paid to the names and titles of those meeting each other. Each person spends a moment actually reading the card before tucking it away.
 - **Title confusion.** Frequently, executives use an acronym to describe their title. They save space on the card, and think they appear less



Self-important. However, these titles can mean very little in other Nations. For instance, in the USA one sees cards with titles such as CEO, CFO, GM or Ph.D. (chief executive officer, chief financial officer general manager, doctor of. Many people have no idea as to what the acronyms means.

- **Art confusion.** Many companies- use fancy logos as part of their marketing communications program. These emblems are used on company business cards. They are fine on a domestic basis, but they can be confusing in other nations. The same is true for cards that feature, small type or fancy colors. They can be very hard to learn from by People from other nations.
- ***In-country language.*** Make a judgment as to whether it is needed at your global show, but if you attend an in-country event for its domestic community, it can be a good idea to have cards printed With your own language on one side, the host country language on the other. The degree of difficulty in having this done differs consider early, depending on where you are going. The service may be offered in the exhibitor kit. Or, for instance, if you are going to China through Hong Kong, your hotel will send out a copy of your standard card, and they will return a box of dual language cards within a few hours.
- **Use of Names.** Though not as critical at worldwide events, it is wise to have a basic understanding of how names are used in different cultures. Here are some illustrations.

USA. Mary Ann Knauss Fish would be addressed as Ms. Fish, her Husband's last name, which appears at the end of the name string on her card. Mr. Edward Chapman, Jr., would be addressed as Mr. Chapman. *Parts of Europe,* in Holland, for instance, Ms. Fish's card would be printed, Ms. Mary Ann Fish Knauss Her husband's name appears first. You would still address her as Ms. Fish. Mr. Chapman remains Mr. Chapman. *Latin America.* A formal name includes the last names of both parents. However, the name string is printed differently depending on culture. For instance, much of Latin America is based on Spanish tradition. Were Edward Chapman to come from one of those nations,



his name would be Edward Chapman Moore. He would be addressed Mr. Chapman again, his father's name, printed first in the international

3.3 Body Language

Take the lead from your visitor. However, be restrained. When you just getting started with a new person, or on the side of conserve even if the delegate seems gregarious-perhaps a Russian, Australian.

Avoid gestures that convey specific meanings as they may not very the same meaning in other lands. For instance, in the USA as p ic gesture used occasionally is a circle made by touching the tips 0 thumb and first finger together. Its meaning: Everything is Okayed correct. In some other cultures the same gesture is an obscenity Japan it signifies money.

Bowing. In a large number of nations bowing is used frequently I sign of respect, especially at the start and conclusion of conventions or meetings. However, there are many different types. J global show can you remember that when meeting with a per from Thailand, it is best to bow with fingers of both hands pres together in a small "prayer" gesture? Probably not.

3.4 Business Dress

Again, unless asked, be yourself as you would be at home,The side of conservatism. It may be that you are exhibiting in a hot c mate and most delegates will be wearing open neck clothing.



4 BANKING AND FINANCE OF USA

4.1 INTRODUCTION

Community Development Financial Institutions (CDFIs) play an important role in our communities. They also play an important role at Bank of America. While CDFIs are an effective way for financial institutions to channel capital to communities in need of development, they can also be strategically approached as an effective tool for investors

CDFIs provide grassroots funding to borrowers that traditional banks may not have the resources to reach. They differ from conventional financial institutions in that they focus on a community development mission as well as their own portability. The loans they make often require extensive staff time per transaction plus provision of technical assistance to help borrowers use funds effectively. CDFIs are uniquely positioned to bring together loan capital with the technical assistance that is crucial to successful lending in this arena. They also are eligible to access public and grant sources to fund the assistance.

Bank of America has a long history of investing in CDFIs and created a formal CDFI program in 1996. At year-end 2001, the company had 98 relationships with CDFIs, representing 135 investments with nearly \$190 million in funds committed or outstanding. CDFI loans and deposits are delivered through market-based Community Development Lenders along with a variety of other community development banking products and other banking services. There is a centralized staff to provide administrative support for underwriting, closing and monitoring CDFI products.

As with any investment, banks need to strategically partner with CDFIs. Fundamental to a successful strategy is the precept that loans must be repaid and that not every application will qualify for approval. Banks are facing more limits on equity, and only when loans are repaid can the flow of capital continue to circulate, creating stronger, more effective CDFIs and bringing sustainability to their endeavors. With the right



approach, banks can ensure that CDFI investments will make good business sense as well as a positive impact in underserved communities.

We have found three key assessments for an effective CDFI investment strategy. First, assess the market context within which a CDFI operates. Second, assess the CDFI's capacity to succeed. Third, assess the opportunity to interact with the CDFI on more than one level — to partner in activities such as affordable housing or workforce development. All are key to ensuring sustainability. (Please see the National Community Capital Association's CDFI peer group and key ratio analysis in the electronic article ("growing Opportunities in Bank CDFI Partnerships.")).

4.2 Assessing market context

At the outset, a bank must recognize that there are certain advantages and disadvantages to using a particular CDFI vehicle based on market context. For example, when neighborhood residents need access to basic financial services such as checking and savings accounts, a community development credit union may be an appropriate market alternative. We place insured deposits in community development credit unions to increase their liquidity and capacity to serve the unbaked. Community development credit unions vary considerably. Some are faith-based, such as the TBC Federal Credit

Union in Richmond. Others may serve particular ethnic groups, such as *Cooperativa Comunitaria Latina de Credito*, the Latino Community Credit Union in Durham, NC.

When there is an entrepreneurial culture in a community and limited employment opportunities, a micro enterprise fund — such as ACCION Texas, headquartered in San Antonio might be the best vehicle to address the community's needs. When the need for capital is more broadly based, a community development loan fund such as the New Mexico Community Development Loan Fund might be the appropriate mechanism. We typically make loans with terms of up to ten years to such lenders.



4.3 *Assessing capacity for success*

As a result of the extensive staff time and technical assistance required to make the loans, in-kind or financial support is often needed to help a CDFI cover transaction costs and become self-sustaining. An objective assessment of such needs and a plan for helping the CDFI meet them should be part of a bank's evaluation of the CDFI.

CDFIs must follow sound business principles to succeed. How well they do so can be a good indicator of their potential for success. Key factors that banks should look for include:

- **Clear Strategy.** Is the CDFI's strategy well articulated and understood both by CDFI personnel and the community?
- **Strong Management.** Does the CDFI have strong staff leadership and an actively involved board?
- **Market Driven.** Does the CDFI respond to the evolving needs of the market?
- **Appropriate Financial Structure.** Does the CDFI have the right mix of grants, interest income and other revenue to sustain business objectives?
- **Balanced Success Measures.** A commitment to community development isn't enough. An appropriate balance between mission and successful lending is all-important.
- **Distinct Credit Culture.** Does the CDFI have a clear approach to lending, with appropriate credit policies and procedures in place?
- **Risk Management.** The CDFI must have policies in place to manage the key drivers of the business: portfolio mix, adequate reserves, interest rate spread and asset/liability management.



4.4 Partnering on other levels

While it may not be feasible in every case, looking for ways to expand a relationship should always be part of a bank's CDFI investment strategy. In addition to providing capital, banks can provide other mutually beneficial services, such as treasury management and other depository services. This partnership should yield referrals and create opportunities for close teamwork on loan and development projects.

To illustrate, we've developed a relationship with the Low Income Housing Fund (LIHF) that transcends conventional CDFI investing. LIHF was founded in 1984 to address the housing needs of low- and moderate-income families and communities. In 1996, Bank of America made a \$1 million CDFI loan to capitalize a revolving fund for loans to be made in the bank's market areas. Based on the success of this initial loan, we were able to make another loan of \$5 million in January 2001. In addition, we placed a \$5 million deposit with the CDFI, qualified by the state of California through the California Organized Investment Network for an investor tax credit. The combination of a Bank Enterprise Award (BEA) received on this loan (see below) and the tax credit enabled us to make the loan on more favorable terms than would otherwise have been possible.

We've also worked closely with LIHF to develop affordable housing. In November 2001, the Wakeland Housing and Development Corporation and the San Diego Interfaith housing Foundation opened Vista Las Flores, a 28-unit affordable housing project. LIHF provided the soft-cost financing that is often difficult to obtain for such projects: technical assistance and a \$150,000 predevelopment loan funded from the revolving loan fund. Bank of America, in turn, provided the construction financing for the project through its Community Development Banking group. Financial teamwork brought the project to fruition.

BEA and CRA: Under the CDFI Fund's Bank Enterprise Award (BEA) program, banks can apply for federal awards for qualified investing in certified CDFIs and for making other specific types of community development investments. We've used BEA to build a firm foundation and a safety net under our CDFI program. Since below market returns on CDFI investments are typical, the BEA program awards can either augment return or can



help to fund loan loss reserves.” The BEA program has been critical to our success in leveraging capital for deployment as CDFI investments,” says Mary Schultz, CDFI investment manager at Bank of America. CDFI investments can also earn CRA credit for banks as indirect investments where few direct investment opportunities may exist. (Please see the sidebar about the BEA program in “bank Enterprise Awards and New Markets Tax Credits: Two Tools to Increase the Flow of Private Capital in Targeted Markets.”)

What is the key to our success? We’ve adhered to a clear strategy, worked with effective partners, and leveraged resources. As a result, we’ve been able to create affordable housing, employment opportunities, community facilities □ and a sustainable program. Although our available capital for CDFI investment is currently oversubscribed, we hope to do more lending as loans are repaid and more funds are allocated to our program. And we will talk now about development of us banks for the last 20 years to see how it s work.

In the last quarter of 1983, the Federal Reserve returned to a restrictive monetary policy. The real money supply, M1 in constant dollars, was essentially unchanged for four quarters and real and nominal interest rates rose. As interest rates rose, the condition of savings and loan associations again worsened. Now thrift institutions had to pay market interest rates on their liabilities, but the bulk of their assets were still in low yielding mortgage loans.(16)

The government responded to the continuing crisis with a series of patchwork delaying actions that were designed to postpone the inevitable day of reckoning. First, regulatory agencies were authorized to continue the set of emergency actions that had been specified in the Garn-St Germain Act beyond the original three-year time span. Second, the FHLBB under its Chairman, Edwin Gray, attempted to protect the FSLIC from growing losses by banning .brokered deposits, an arrangement in which savings and loan associations acquired insured certificates of deposit through investment advisors and stock brokers from investors in amounts that did not exceed the maximum amount of \$100,000 that the FSLIC would insure. Gray recognized that such deposits provided operators of associations with extraordinary access to funds that would seriously impair .



the understaffed FSLIC's ability to regulate rapidly growing associations. His ban was successfully challenged in court. Third, in 1985 the Board finally found a way to bypass Reagan administration resistance to expanding the number of examiners. The number of examiners more than doubled between 1984 and 1988 and their budget more than tripled.(17)

Fourth, a government capital injection to the FSLIC became necessary because it was insolvent. After M. Danny Wall replaced Edwin Gray as chairman of the FHLBB, Congress passed the Competitive Equality Banking Act of 1987 (CEBA) that President Reagan signed in August. It authorized the FSLIC to borrow \$10.825 billion and established the Financing Corporation (FICO), a new government agency that was authorized to borrow an additional \$15 billion that could be used to finance restructuring of savings and loan associations. The Congress exacted a high price for this assistance when it insisted that the FSLIC exercise extreme regulatory forbearance in the Southwest (especially Texas and Oklahoma) where savings and loan associations had been severely impacted by falling oil prices.

In addition to high costs of deposit liabilities, savings and loan associations encountered two other obstacles in their struggle for survival. First, federal housing credit programs offered by FNMA, GNMA, and FHLMC were capturing a steadily increasing share of mortgage markets. By 1988 nearly 40% of all mortgages on houses for 1 - 4 families benefited directly from these programs; as a result interest rates on mortgage loans fell relative to those on bonds with comparable maturities.(18) Mortgage loans were more than fifty percent of savings and loan asset portfolios. Second, expanded lending powers provided by DIDMCA and the Garn-St Germain Act allowed savings and loan associations to acquire diverse other assets in markets where their expertise was very limited. Losses from incompetence, corruption, and dubious investments were high(19)

The number of associations steadily dwindled, from 6,320 in 1960 to 3,825 in 1982. More ominously, if assets were being marked to market, the number of continuing associations with negative net worth was rising. By yearend 1989 more than one-third of the 2,878 surviving saving and loan associations with nearly forty percent of industry



assets were unprofitable. Collectively their tangible net worth was negative \$23.7 billion and their after-tax 1989 net income was negative \$24.4 billion. The entire industry had a miniscule tangible net worth of \$10.1 billion to back up \$946 billion in deposits and it had 1989 after-tax net income of negative \$19.2.(20).

The ratio of profits to assets at commercial banks also declined after 1982. Large realized and unrealized losses on third-world loans by money center banks were part of the problem. Growing competition in financial markets from nonfinancial corporations and overseas banks, together with relaxation of barriers to intrastate banking eroded long-standing monopoly rents of banks. Money market mutual funds continued to pay high interest rates, which increased the cost of deposits to banks. Savings and loan associations also continued to contest consumer markets by paying high interest rates on brokered time deposits. Falling profits were unevenly distributed across commercial banks; bank failures reached levels in the United States not seen since the early years of the Great Depression. The number of insured commercial banks (21) that ceased operations rose from 4 in 1981 to a peak of 261 in 1989. The number of insured banks fell from 14,512 at the end of 1984 to 10,514 at the end of 1994. At the end of 2001, there were 8,129 commercial banks.(12)Disappearing banks were being bought up by other banks and converted into branches, voluntarily closed, or closed by bank regulators. It should be noted that the number of existing banks includes a large number of newly chartered commercial banks and institutions that converted from mutual savings bank and savings and loan association charters to commercial banking charters.

Quite apart from changes in the number of banks, Amel and Jacowski [1989] reported that between 1976 and 1987 there was a major restructuring of the organization of U.S. commercial banking. In 1976 there were 10,608 independent banks that controlled 30% of domestic banking assets. By the end of 1987 there were 4,375 independent banks that controlled 9% of domestic assets. In 1976 there were 301 multibank holding companies that controlled 36% of domestic banking assets; by the end of 1987 there were 985 that controlled 70% of domestic assets. The remaining category, one-bank holding companies, saw their share of domestic banking assets shrink from



34% to 21% between these two dates. The new or rapidly expanding multibank holding companies tended to be regional organizations with little third-world loan exposure. An interpretation is that banks were responding to increasing competition from nonbanks by merging to reduce intra-industry competition.

Between 1984 and 1994 commercial banks were greatly increasing the amount of mortgage loans in their portfolios. There are several candidate explanations for this shift. First, banks were facing aggressive competitors in all loan markets, but the weakest competitors were the crippled and disappearing savings and loan associations. Banks were not as heavily burdened with low fixed interest rate mortgage loans as savings banks and savings and loan associations, so they could undercut these rivals. Second, adjustable-rate mortgages (ARMs) were increasingly being accepted by regulators and the public. This meant that banks could now make mortgage loans and not have the large negative gap that the savings institutions experienced. Third, the growing secondary markets in mortgage-backed securities that had been developed by GNMA and FHLMC had made mortgage loans very liquid. Banks could reasonably expect to be able to securitize and sell them if conditions changed.

Further, the Tax Reform Act of 1986 profoundly changed the extent to which households could deduct loan interest from taxable income. Before the change essentially all interest payments could be deducted from taxable income. After the change, interest payments could only be deducted if the proceeds were used to finance medical, educational, etc. expenses or to finance residential property, i.e. was a mortgage loan secured by residential property. Banks and other lenders rapidly expanded mortgage loans to exploit this tax law revision. A major innovation to achieve this goal was the home equity line of credit. A home equity line of credit allows house owners to borrow funds against the equity in their houses. The funds are fungible in that they can be used for almost any purpose, and the interest continues to be deductible. Table 3 shows mortgage loans and mortgage-backed securities as a percentage of total commercial banking assets. The table understates bank financing of real estate because most, but not



all, government agency paper in bank portfolios is used to finance government-sponsored mortgage programs. Home equity lines of credit are shown only if a line has been activated and, then, only the amount borrowed against the line is included in real estate loans. The data are unavoidably incomplete, because the Federal Reserve did not publish information for collateralized obligations and private securities (22) in early years. The missing series are undoubtedly small and the overall trend between 1985 and 1991 is clear; there was no meaningful trend between 1991 and 1999, but the trend again appears to have turned positive in 2000 and 2001.

The bad experience of the savings and loan industry was a result of its large negative gap. Banks and other investors learned from that experience and seemed to have controlled their gaps, positive or negative, with adjustable rate mortgages and instruments available on financial futures and options exchanges. Additional instruments for controlling exposure to gaps included swaps and stripped securities.²² These instruments and their elaborate variations are priced using the then relatively recent results from the theory of finance, especially the option-pricing model of Black and Scholes [1973] and its extensions.

On August 9, 1989, the government finally took actions to clean up the mess in the savings and loan industry when President George H. W. Bush signed the Financial Institutions, Reform, Recovery, and Enforcement Act of 1989 (FIRREA). This very complex bill eliminated the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation and replaced them respectively with the Office of Thrift Supervision (OTS) and the Savings Association Insurance Fund (SAIF). The Federal Deposit Insurance Corporation (FDIC) was assigned the responsibility for managing SAIF and another fund, the Bank Insurance Fund (BIF). The two funds established different insurance premiums, which were less onerous for commercial.



Table 3

Real Estate Loans and Securitized Mortgage Debt in Commercial Bank Portfolios
(Expressed as a percentage of average net consolidated assets)

year	real estate loans	mortgage pass-through securities	collateralized mortgage obligations	private mortgage- backed securities	total
1985	15.88	0.96	n.a.	n.a.	n.a.
1986	16.90	1.13	n.a.	n.a.	n.a.
1987	19.00	2.10	n.a.	n.a.	n.a.
1988	20.86	2.59	n.a.	n.a.	n.a.
1989	22.50	3.27	n.a.	n.a.	n.a.
1990	23.86	4.08	1.28	n.a.	n.a.
1991	24.86	4.51	2.07	0.94	32.38
1992	24.87	4.52	3.12	0.82	33.33
1993	24.80	4.74	3.72	0.73	33.99
1994	24.43	4.67	3.24	0.64	32.98
1995	25.01	4.47	2.67	0.62	32.77
1996	25.06	4.80	2.11	0.61	32.58
1997	25.02	4.94	1.94	0.50	32.40
1998	24.87	5.17	2.13	0.67	32.84
1999	25.44	5.24	2.15	0.88	33.71
2000	27.04	4.75	1.92	0.95	34.66
2001	27.10	5.13	1.96	1.09	35.28

Sources: Various annual articles entitled "Profits and Balance Sheet Developments at U.S. Commercial Banks in [year]", that appear in June or July



Banks. Supervision of the twelve Federal Home Loan Banks was transferred to a new organization, the Federal Home Finance Board (FHFB). Responsibility for liquidating insolvent savings and loan associations was assigned to another new agency, the Resolution Trust Corporation (RTC), which was also managed by the FDIC. The cost of this clean up would be very large, although the exact amount is not known. Its present value in 1989 was probably on the order of \$150 billion. Responsibility for managing it as assigned to the Resolution Financing Corporation (RFC), which was authorized to borrow an additional \$50 billion. Other RFC funds came from reserves and future net income of Federal Home Loan Banks; these assessments served to increase the costs of savings and loans and thus favored commercial banks. There were a number of further large expenditures for the saving and loan disaster as a result of a threatened default by FICO and a court decision that FIRREA violated promises made by the government in the Garn-St Germain Act their details are not important for the present discussion.

In 1991 growing concern about the solvency of the FDIC that came from the continuing wave of commercial bank failures led to the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This act authorized the FDIC to borrow to meet its obligations. It also incorporated reforms that gave the FDIC the goal of attempting to minimize its potential losses when fulfilling its responsibilities of insuring depositors. In particular, it put pressure on the Corporation to avoid resorting to a doctrine of .too big to fail. Which had been invoked when large banks got into difficulty. An example is when the Continental Illinois National Bank and Trust Company failed in 1984. In terms of total assets it was the largest bank failure in U.S. history and was estimated in 1997 to have cost the FDIC \$1.1 billion. While large, it was greatly exceeded by costs the FDIC experienced when resolving failures in 1988 and 1989 of the large Texas banks, First Republic bank Corp. (\$3.77 billion) and Dallas (\$2.85 billion).(23)

The reason for these large payments was that the FDIC reimbursed all depositors. losses rather than the \$100,000 per account that they were legally required to insure, because the Corporation apparently feared that systemic failures would occur if uninsured



clients at such large entities were not fully protected. They had shown no such concern for large uninsured depositors at small banks, as in the case of the 1990 failure of the Freedom National Bank in Harlem.

FDICIA modified the structure of premiums that the FDIC could charge banks in order to better reflect its risk exposure. This and the nearly contemporaneous Basle international agreements for determining a bank's minimum required capital would strongly affect banking practices in the years to come, as will be seen in the next section.

Another major legislative reform of banking occurred in 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act. This legislation attempted to simplify a very messy regulatory structure for U. S. banks. A few multi-state bank holding companies had come into existence in the 1920s and continued to exist because they were grandfathered. by the 1927 McFadden Act that banned interstate banking structures. Otherwise, banks and savings and loan associations could only have branches in a single U. S. state. The Garn-St Germain Act of 1982 authorized regulatory agencies to approve emergency mergers between failing savings and loan associations and other financial institutions that sometimes were in different states, if suitable merger partners were not available in a state. Further, mergers between a commercial bank and a savings and loan association were approved if no suitable savings and loan partner were available. Finally, different states had heterogeneous regulations about branching within their borders. Thus, some states would not approve branching within its borders or only branching in limited areas, while others allowed statewide branching. While state restrictions on branching within states were slowly being removed and some states were negotiating bilateral interstate branching arrangements, banking markets continued to be subject to many artificial barriers. The Riegle-Neal Act re-established the chartering of multi-state bank holding companies. Further, unless states opted out within a certain time interval the Act authorized full interstate branching. Only Texas and Idaho opted out.

In principle, the Riegle-Neal Act should have helped bank clients by eliminating a large number of indefensible barriers to entering markets. However, it also led to a wave of mergers that has greatly increased the share of banking system assets in the largest



banks after 1994. The share of banking system assets understates the share of bank lending originated by large banks, because large banks securitize relatively more of the loans that they make. Securitized loans tend to be homogeneous, which may reduce the access to bank credit by promising but idiosyncratic borrowers.(24) Large banks also raise more funds from foreign offices and in non-deposit forms than other banks, which suggests that deposits are likely to decline relative to other financial assets held by households and firms.

VI THE AFTERMATH: 1995, 2002

Debt in the United States had been rising steadily as the economy grew. The U. S. Flow of Funds Accounts indicates that between 1965 and 1980, total credit market debt owed by domestic nonfinancial sectors was approximately 150% of nominal GDP. Between 1980 and 1989 credit market debt rose much faster than GDP, so that by 1989 it was almost 200% of nominal GDP. It fell to 180% at the end of 1994 and then rose steadily to 189% in 2001. Debt growth after 1980 was quite broadly based, but differed considerably across sectors in different sub periods. Between 1980 and 1989 debt of the U. S. government grew 206%, debt of all business grew 145%, debt of corporations grew 162%, debt of households grew 139%, and debt of state and local governments grew 174%. Between 1989 and 1994, debt of the U. S. government grew 55%, debt of all business grew 6%, debt of corporations grew 12%, debt of households grew 36%, and debt of state and local governments grew 19%. Between 1994 and 2001, U.S. government debt fell 3%, debt of all business grew 82%, debt of corporations grew 87%, debt of households grew 69%, and debt of state and local governments grew 24%. Apart from being a longer sub period than others, debt growth between 1980 and 1989 reflects a high rate of inflation, the deep recessions of 1980 and 1982, and the large tax cuts of the 1981-1983 periods. Federal government debt was also growing most rapidly between 1989 and 1994, as the economy suffered another recession and the effects of the tax cuts continued. In part because of tax increases by the first Bush administration and the Clinton administration and the absence of a recession, federal government debt actually shrank between 1994 and 2001. Household and business debt expanded rapidly and perhaps unsustainably in this last sub period.



The manner in which the last sub-period's deficits were financed partly reflects the extraordinary changes in the banking regulatory environment and other developments in financial markets. Changes in total credit market assets (and liabilities) were large relative to changes in GDP. The ratio of total credit market assets to GDP rose from 2.38 in 1994 to 2.87 in 2001. In part this rise reflects the fact that there was growing roundaboutness. In financial markets as intermediaries were increasingly acquiring credit market assets that were issued by other intermediaries. Direct claims on final borrowers by original lenders were a falling share of total credit market assets.

Table 4 reports end of year positions in credit market assets for selected classes of large investors from 1994 through 2001. Holdings of the domestic nonfederal nonfinancial sector were.

Table 4
Total Credit Market Assets Held by Selected Large Investor Classes: 1994-2001
(end of year in trillions of dollars)



investor class	1994	1995	1996	1997	1998	1999	2000	2001
TOTAL	17.2	18.4	19.8	21.3	23.5	25.7	27.5	29.5
<u>Domestic nonfederal nonfinancial</u>	3.0	2.9	2.9	2.9	3.1	3.4	3.2	3.0
households	2.0	1.9	2.0	2.0	2.0	2.3	2.1	1.9
<u>Federal government</u>	0.20	0.20	0.20	0.21	0.22	0.26	0.27	0.27
<u>Rest of world</u>	1.2	1.5	1.9	2.3	2.5	2.7	3.0	3.4
<u>All financial</u>	12.8	13.8	14.7	15.9	17.6	19.4	21.1	22.8
commercial banking	3.3	3.5	3.7	4.0	4.3	4.6	5.0	5.2
savings institutions	0.9	0.9	0.9	0.9	1.0	1.0	1.1	1.1
life insurance	1.5	1.6	1.7	1.8	1.8	1.9	1.9	2.1
MMMFs	0.5	0.5	0.6	0.7	1.0	1.1	1.3	1.5
other mutual funds	0.7	0.8	0.8	0.9	1.0	1.1	1.1	1.2
government-sponsored enterprises	0.7	0.8	0.8	0.9	1.3	1.5	1.8	2.1
federally related mortgage pools	1.5	1.6	1.7	1.8	2.0	2.3	2.5	2.8
ABS issuers	0.5	0.7	0.8	0.9	1.2	1.4	1.6	1.9
finance companies	0.5	0.5	0.5	0.6	0.6	0.7	0.9	0.9

Sources: Federal Reserve statistical release Z.1, Flow of Funds Accounts of the United States, March 12, 1999 and March 7, 2002.

Notes: Table excludes corporate equities and mutual fund shares. The row .TOTAL. is equal to the sum of the underlined sectors.



Essentially flat over this period. Holdings of the federal government were rising, but too small to merit discussion. Holdings of the rest of the world nearly tripled; the U. S. partly financed its huge trade deficits by transferring credit market assets to foreign investors. Credit market assets of all financial institutions rose 78% between 1994 and 2001. Commercial banks. Credit market assets rose 60% during this interval. More than savings institutions and life insurance companies, but less than the other financial institutions shown in the table.

The highest rate of growth was by asset-backed security issuers, which are special purpose vehicles that issue commercial paper and corporate bonds that are secured by financial and other assets. Commercial banks, savings institutions, finance companies, and other institutions such as leasing companies originate many of the assets they hold. The high growth rate of issuers of asset-backed securities reflects efforts by commercial banks and other intermediaries to get assets off their balance sheets. By moving assets off balance sheets banks can continue to earn income from servicing assets they originate without violating minimum capital requirements that were established in the Basle agreements or by regulatory agencies. Further, banks avoid deposit insurance premiums, if assets are not financed by deposits. Typically acquirers of asset-backed commercial paper and corporate bonds have little recourse to originating institutions or asset-backed security issuers if defaults occur; so asset-backed security issuers are effectively redistributing risk to a broader group of investors. Commercial bank holding companies administer many issuers of asset-backed securities.

Other issuers of securitized debt in Table 4 have also been growing rapidly. Federally related mortgage pools issue securities that are backed by mortgage loans. They compete with private asset-backed security issuers. Because of their association with the federal government, they are perceived to be somewhat safer, can pay a lower interest rate than comparable private sector issuers, and trade in a highly liquid market. As is evident in Table 3 about twenty percent of bank credit to real estate markets takes the indirect form of mortgage-backed securities.



Government sponsored enterprises issue securities that are backed by loans made by agencies established by the United States government. They exist essentially for cosmetic reasons, because the government does not want such paper counted as part of its full faith and credit debt. The securities are analogous to debt that is issued by a subsidiary of a private corporation. While such debt might seem risky, there is a widely held view that the government would reimburse investors for any losses in the event of a default. As a result such debt pays lower interest rates than low risk private debt. Roughly forty or fifty basis points more than full faith and credit U.S. government debt of comparable maturity. In 2000 more than ten percent of commercial banking assets were government agency securities, which contribute to their aura of being a safe asset. Agency securities are attractive because in addition to paying a higher rate than treasury securities they can be used in repurchase agreements.

Money market mutual funds have also been growing very rapidly in recent years. As explained earlier, they have a technical advantage because by construction these funds can never have a gap problem. Their holdings are mostly short-term agency securities and commercial paper. Securitization often requires the help of investment bankers. Beginning in 1987, some large bank holding companies were authorized by the Federal Reserve to establish subsidiaries that could underwrite state and local government revenue bonds; they were called Section 20 subsidiaries because they are allowable under Section 20 of the 1933 Glass-Steagall Act. Initially, the amount they could underwrite was limited by a condition that the revenue from underwriting could not exceed five percent of the subsidiary's total revenue. This decision by the Federal Reserve Board was the first crack in the separation of commercial and investment banking, which had been mandated by the Glass-Steagall Act.⁽²⁵⁾ The crack widened in 1989 when the Federal Reserve relaxed the restriction on revenue from five to ten percent of a subsidiary's revenues and again in 1996 when the restriction was eased from ten to twenty-five percent. In 1997 the Federal Reserve eliminated all firewalls for Section 20 subsidiaries.⁽²⁶⁾

On April 6, 1998 the largest U. S. bank holding company, Citicorp, and the Travelers Insurance Group announced a merger, which effectively threw the gauntlet



down at the feet of the federal government. There was no legislation at the time that allowed such a merger to be sustained. Because the Travelers Group owned an investment-banking firm, Solomon Smith Barney, the proposed merger was in violation of the Glass-Steagall Act. The transaction was effected by having the Travelers Group buy Citicorp and then applies to the Federal Reserve to become a bank holding company, Citigroup. Under the Bank Holding Company Act, the Federal Reserve was authorized to grant new holding companies a two-year window in which to dispose of activities that were not allowed under the Bank Holding Company Act. Two years were not required because a 1999 law eliminated the problem.

On November 12, 1999 President Clinton signed the Financial Services Modernization Act (also known as the Gramm-Leach-Bliley Act). This act repealed restrictions on banks affiliating with securities firms that appeared in Sections 20 and 32 of the Glass-Steagall Act, thereby obviating the need for the two-year window. The act introduced a new construct, a financial holding company, which could engage in a statutorily approved list of activities that included insurance, securities underwriting, merchant banking, and complementary financial undertakings. The Federal Reserve is responsible for overseeing the regulation of financial holding companies; various state and other federal agencies are charged with continuing to regulate activities (functions) provided by affiliates of a financial holding company. At the end of 2001, there were 672 financial holding companies. The Financial Services Modernization Act is extremely intricate and incorporates much political compromise and grandstanding. A thorough exposition is beyond the scope of the present paper. It is important to note, however, that the act preempts state laws that had limited affiliations among financial firms and radically restructures Federal Home Loan Banks. Henceforth, the Federal Housing Finance Board no longer controls Federal Home Loan Banks. Further, commercial banks with less than \$500 million in assets may use long-term FHLB loans to finance loans to small firms. Press reports at the time of the signing of the Financial Services Modernization Act had predicted a sweeping restructuring of financial markets. It is difficult to confirm that such revolutionary restructuring is occurring so soon after its passage, but change continues.



4.5 AN OVERVIEW AND SUMMARY

To a considerable extent the financial system has reverted to a mixture of the system of the 1920s and a new system where there is massive government intrusion in capital markets. The consequences of this intrusion are poorly understood and difficult to analyze. For example, what happens if FNMA or some Federal Home Loan Banks get into difficulty? The transition has been fumbling and costly; larger costs in present value terms are likely in the future. Depositors and borrowers at commercial banks can anticipate receiving a new and different set of services, which in some respects are better and in others worse than they received seventy-five years ago.

a) *Comparing the 1920s and the 1990s.* To begin with, consider the system of the 1920s. Banks could pay interest on demand and time deposits and were able to conduct both commercial and investment banking. Before 1927 interstate bank holding companies existed and banks had branches in different states. Banking instability was widespread; between 1921 and 1929 more than 5,400 banks suspended operations. There was no federal deposit insurance.

Between June 1920 and June 1929, total commercial banking system deposits rose 36%, from \$36 to \$49 billion.⁽²⁷⁾ Deposits of banks that were members of the Federal Reserve System rose from \$25 billion to \$36 billion in the same period.⁽²⁸⁾ In real terms, percentage changes in deposits should be adjusted upward because major price indexes fell about ten percent in the 1920s.⁽²⁹⁾ Business loans fell as a percentage of all bank loans and investments from 47% to 33% between 1922 and 1929. Nonfarm residential mortgage loans on commercial bank balance sheets doubled as a percentage of banking system assets during the 1920s; they were 8% in 1929. For banks that were members of the Federal Reserve System, all securities (loans) expressed as a fraction of total assets were 18% (59%) at the end of 1920 and 20% (55%) at the end of 1929. For member banks, U. S. government securities were 8% of total assets on both dates.⁽³⁰⁾



For all U. S. banks, corporate bonds rose from 8% of banking system assets in 1920 to 11% in 1930. There were large amounts of overnight call loans, which served as short-term secured loans, much like repurchase agreements today. In 1925 loans on security collateral were 29% of all loans at national banks. Like repurchase agreements, many overnight lenders in the call market were nonfinancial corporations; 70% of the \$9.2 billion of loans to brokers and dealers came from such corporations in October 1929.(31) Federal funds were traded among members of a clearinghouse, but a national market did not exist until the fed wire was established in 1928.

There are marked similarities between the 1920s and the 1990s, especially the late 1990s. Banks are now able to pay interest on NOW account balances, time and savings account balances, and deposits they book at overseas branches. Only demand deposit balances in domestic offices pay no interest. As a percentage of average net consolidated assets in all Banks, demand balances in domestic offices have fallen from 13% in 1991 to 8% in 2001 (32) After 1999, financial holding companies could do both commercial and investment banking. Bank failures occurred at a high rate in the 1980s and early 1990s, but there were few losses sustained by depositors because of deposit insurance. There were 1442 bank failures in the United States between 1982 and 1993, which was about half the percentage incidence of the 1920s. The failure rate has been falling since 1988; the FDIC has reported that fewer than ten banks required assistance in each year between 1994 and 2002.(33)

Between December 1990 and December 2001 total assets of domestically chartered commercial banks deposits rose 91%, from \$2.86 to \$5.45 trillion, and all deposits rose 74% from \$2.17 to \$3.78 trillion.(34) After adjusting for differences in the rate of inflation (the consumer price index rose 32% in this time interval), in real terms these growth rates were very similar to those in the 1920s. Outstanding commercial and industrial loans at domestically chartered commercial banks, rose from \$514.7 billion in December 1990 to \$827.6 in December 2001 but, as in the 1920s fell as a percentage of total bank assets from 18% to 15%. Unlike the 1920s when outstanding commercial



paper fell, commercial paper was an increasingly important source of funds for nonfinancial corporations in the 1980s and 1990s. Commercial paper of nonfinancial corporations (all issuers) rose fairly steadily from \$148 (\$562) billion in December 1990 to \$343 (\$1,615) billion in December 2000, but then plummeted to \$225 (\$1,439) billion in December 2001 and to \$189 (\$1,358) billion in March 2002. Nonfinancial corporations borrowed heavily in the bond market in both periods, and especially from overseas investors in the 1990s. Unlike the 1920s, relatively small amounts of funds were raised through new equity issues in the 1990s. Indeed, over the ten-year span 1992-2001 the Federal Reserve's Flow of Funds accounts indicate that the net issuance of equities by U. S. nonfinancial corporate business was slightly negative, while their net issuance of bonds was about \$147 billion per year.

All real estate loans, as a percentage of average net consolidated assets on U. S. commercial bank balance sheets, rose from 25% in 1991 to 27% in 2001. Either figure is substantially more than banks held seventy-five years ago. However, it is difficult to make quantitative comparisons of real estate loans between the 1920s and the 1990s because their properties have changed so much. Mortgage loan maturities in the 1920s typically were five years or less and contracts often specified that a large balloon payment was due at maturity; in recent years many residential mortgage loan contracts have thirty-year maturities. The effective life of mortgage loans in the 1920s was, of course, longer than five years, because loans would often be rolled over, and shorter than thirty years in the 1990s because people move on average about once every five years. In terms of maturity the differences between the two periods is that in the 1920s 1) a bank effectively had an option to call the loan at maturity in the earlier period and 2) had only a limited gap exposure, because interest rates on loans could be set to current market rates when loans matured. The value property's value. Unlike the 1920s, 1990s mortgage contracts could be 1) written with adjustable loan rates, 2) insured against default, and 3) securitized or traded on a liquid secondary market.

Banks held few private sector corporate bonds in the 1990s, but they had large quantities of securitized debt that had been issued by government agencies and large amounts of other direct agency debt. As a percentage of average net consolidated assets



on all commercial bank balance sheets, securities were 21% in 1991 and 20% in 2001. The percentage of consolidated assets that was U. S. Treasury securities fell from 5.1% to 0.9% over these years, as compared to 8% in the 1920s. Thus, agency debt and securitized debt represented a much larger share of bank assets in the 1990s than corporate bonds did in the 1920s. Further, much of this debt was securitized by mortgage loans. While only U. S. Treasury securities are full faith and credit obligations of the government, agency and securitized debt were less likely to default than corporate debt held by banks in the 1920s. However, a collapse in real estate markets could greatly stress U. S. banking markets.

An area of growing risk exposure, similar to that of the 1920s, is in short-term funds. The sum of net federal funds purchased and funds acquired through repurchase agreements, as a percentage of net consolidated assets rose about 10% between 1991 and 2001, from 2.51% to 2.84%. They are likely to be mostly repurchase agreements that are secured by agency debt primarily real estate loans. Another remarkable trend in the 1990s was the sharp increase in other liabilities, as a percentage of net consolidated banking system assets, from 5.0% in 1991 to 9.9% in 2001. Such liabilities are not covered by deposit insurance, and thus represent risk that is being assumed by others in the economy. Their growth rate was inversely related to size of bank.(35) In the 1920s, the sum of borrowings, outstanding acceptances, and other liabilities of all banks that belonged to the Federal Reserve System fluctuated widely; in December 1929 it was 7.1% of total

member bank assets.(36) Because borrowings, in 1929 included federal funds and repurchase agreements, the combined 2001 percentages of total assets that were net federal funds purchased, funds acquired through repurchase agreements, and other liabilities were about 180% of their 1929 counterpart.

b) *Evaluating the changing returns and risk exposures of clients of banks.* How have returns, services, and risk exposures changed over the postwar period? The distortions arising from the Great Depression and World War II severely affected banks, as is evident in Table 1. At the end of 1945, 58% of insured banking system assets were



U. S. government securities and 17% loans. It is important, but not easy, to allow for this severe initial distortion of bank balance sheets. Bankers as well as balance sheets had been through a wringer; they remembered all too well how vulnerable they were to economic shocks. As a first approximation, it seems reasonable to argue that the traumatizing effects of the depression and war largely defined bank portfolios until perhaps 1955. Banks were taking few risks and provided few new services. To be sure, there were relatively more loans and smaller holdings of U. S. securities; at the end of 1955 loans were 39% and U. S. government securities were 29% of insured banking system assets. But, as noted above, banks were not paying competitive interest rates on time and savings deposits and, relative to the 1920s, still had large amounts of liquid government securities. They were not stretching their resources to accommodate lenders.

This relaxed period disappeared roughly between 1955 and 1957 as the Federal Reserve took actions that sharply raised interest rates in an effort to fight inflation. The prime loan interest rate rose 50%, from 3% to 4.5% in these years. Firms began to seek longer term loans from banks and both the federal funds and commercial paper markets revived.⁽³⁷⁾ As noted above, bank interest rates on consumer time deposits began to rise rapidly between 1957 and 1963, closing the spread between what commercial banks and savings and loan associations paid. Bank net income as a percentage of all member bank assets reached a local maximum value in 1960, 0.84%, which was not surpassed until 1992. In the next years this bank profit measure began a prolonged decline as interest rates on deposits continued to rise and large banks introduced negotiable certificates of deposit.

This golden age for bank depositors came to an end in 1966, when Congress and regulators intervened by imposing ceilings on rates that could be paid on deposits in order to prevent a prospective wave of failures in the savings and loan industry. The intervention was initially especially damaging to borrowers, as the foregoing narrative suggests, because depositors were able to avoid the ceilings by acquiring assets that did not have them. Because savings and loan associations were largely limited to making mortgage loans, borrowers in real estate markets were savaged until FNMA was

privatized and GNMA and FHLMC were respectively established in 1968 and 1970. However, depositors were also penalized when inflation rates began to exceed the rates banks and others were able to pay. Especially if one takes into account taxes that were paid on interest income.

The events of this period pose an interesting question: Was the crisis in 1966 a consequence of uninformed myopic market behavior by banks and savings and loan associations or a serious flaw in system design? While it is true that government insurance funds would suffer losses if banks or savings and loan associations failed, few failed because of the imposition of interest rate ceilings. In 1965 and 1966 both intermediaries were paying higher rates on deposits than were sustainable, because they lacked the ability to raise interest rates sufficiently on the assets they held. As a short-run struggle for market shares, it was a classic example of overshooting that accompanies market clearing, which has been described by A. W. Phillips [1954, pp. 297-9] as integral stabilization.. However, the competitors were not fairly matched because savings and loan associations were mostly invested in long-term real estate loans and had a much larger negative gap. Congress and government regulators, who required them to have this portfolio specialization and gap, stopped the competition. The system was also flawed because there was too little private sector interest (stakeholders) in the survival of savings and loan associations. Most savings and loan funds were lodged in mutually chartered institutions. In such institutions there are no stockholders with an investment that could be lost. Management had a stake, but apart from losing their jobs they were unlikely to suffer penalties if an institution failed. Many managers and members of boards of directors had conflicts of interest because they often were affiliated with other firms that transacted with an institution. In stock-chartered savings and loan associations, owners were often similarly conflicted. This was also a system design flaw. In these circumstances Congress and regulators were unwilling to let the struggle play itself out. By imposing ceilings the government applied a palliative, but failed to address the underlying structural deficiencies and thereby precipitated the subsequent chaos.

The period between 1970 and the passage of the Monetary Control Act on March 31, 1980 is best viewed as an unseemly struggle among 1) depositors who were



struggling (mostly unsuccessfully) to earn a positive rate of return on their savings, 2) borrowers who were struggling (mostly successfully) to earn a high rate of return on their leveraged tangible investments, and 3) the Federal Reserve who was struggling (destructively and mostly unsuccessfully) to fight inflation. Congress and three ineffective presidents largely watched from the sidelines. The events, outcomes, and victims were described in Section IV.

Because real interest rates were borderline negative during much of the decade, the trade-weighted value of the dollar fell about one-third and the U. S. current account balance was positive on average. A falling value of the dollar meant that U. S. firms could remain competitive in global markets without substantively restructuring themselves. Borrowers who were exporters benefited strongly during these years. Firms in Europe and Japan were forced to improve technology, which paid them high dividends in the following decade. Speculators responded to the falling value of the international exchange standard, the dollar, by bidding up the price of gold and silver to absurdly high levels. European countries began serious efforts to construct a substitute for the dollar by limiting bilateral fluctuations in the values of their currencies.

After MMMFs became big players in 1978 and the Garn-St Germain legislation was enacted in 1982, which created new high-yielding deposit accounts, depositors began to gain . at the expense of borrowers, insurers of deposits and, eventually, taxpayers. The Fed's restrictive monetary policy, beginning in late 1978, and the series of large Reagan administration tax cuts caused both nominal and real interest rates and the trade-weighted value of the dollar to rise sharply; the trade weighted index (1973 = 100) nearly doubled from 85.5 in January 1980 to 158.4 in February 1985. The Federal Reserve won the battle against inflation, but its efforts continued to inflict heavy losses on several sectors of the economy. The real cost of funds to borrowers soared and newly cheap imports from Japan and Europe severely impacted American manufacturers. Much of the U. S. Midwest became a .rust belt, as firms bore the brunt of the fight against inflation. The survivors who could borrow and afford the high cost of funds effected a major



restructuring of industries, which would yield high returns in the 1990s, like those realized by firms in Japan and Europe in the 1980s. Beginning with the Plaza Hotel agreement of September 1985, an international campaign was undertaken to reduce the value of the dollar. This campaign contributed to a decrease in the U.S. merchandise trade deficit after 1987 and a sharp fall in the trade-weighted value of the dollar to 89.0 in April 1988. The merchandise trade deficit fell from \$160 in 1987 to \$74 billion in 1991.

The falling exchange rate together with the restructuring of industries helped to improve the rate of return to firm's. Especially those with an export specialization. Because real interest rates were falling, most borrowers were gaining relative to depositors, but real interest rates remained high until the early 1990s.(38) As noted in Section V, the Tax Reform Act of 1986 changed rules on the deductibility of interest by households, which strongly favored individuals who could arrange a loan secured by residential real estate. Individuals who owned one or more homes gained at the expense of renters. The effects of the reform act were a surge in demand for real estate loans, which is partly evident in Table 3, and a disproportionately higher rate of inflation of housing prices. The yearend ratio of homeowners. Equity in household real estate to its value decreased almost monotonically from 65.8% in 1989 to 54.2% in 1999; it was 54.9% at the end of 2001. Thus, leverage and the risk exposure of borrowers rose as homeowners sought to take advantage of the return from the almost unique tax shield afforded by mortgage loans.

The tax reform act also limited the deductibility of losses that investors could take on passive investments in commercial properties, which reduced the effective demand for mortgages on commercial properties. The passage of the act coincided with a construction boom in commercial properties, with the result that a glut of commercial buildings developed that was accompanied by very high vacancy rates and falling prices and rents.(39) Commercial real estate loan losses coincided with and contributed to the high rate of bank failures during this period and the mild recession of the early 1990s.



The Federal Reserve responded to the crisis tardily but aggressively by driving the real federal funds rate down to near zero in late 1992 and 1993. The effect of this intervention was to allow banks to sharply reduce the nominal interest rates that were being paid on deposits. For example, in January 1990 NOW accounts were paying 4.97%; they were only paying 1.84% in January 1994 and 1.98% in November 1996, when the Fed stopped reporting these rates.⁽⁴⁰⁾ Using the contemporaneous GDP price deflator, real interest rates paid on NOW accounts fell from about +0.50% to -0.25% between 1990 and 1994. Similarly, on time deposits with a maturity of more than two and one-half years, the nominal interest rate banks paid was 7.86% in January 1990; they were paying 4.30% in January 1994 and 5.65% in September 1997 when, again, the Fed stopped reporting these series. Depositors suffered from the Federal Reserve's policies in the early 1990s.

Beginning in 1994 the Fed reversed course and drove the federal funds rate sharply higher, from 2.96% in December 1993 to 5.92% in March 1995. The real federal funds rate also increased about 300 basis points between these two dates. The nominal federal funds rate was reduced slightly in 1995, but the target rate varied between 5.25% and 5.50% between December 1995 and the Long-Term Capital Management crisis of October 1998. The real federal funds rate drifted up over this 34-month span, but was insufficient to arrest an expanding bubble that had developed in the stock market. A rising torrent of funds from overseas resulted from the growing U. S. trade deficit and an appreciating U. S. dollar fed securities markets. The negative net issues of corporate equities between 1995 and 1998, which are reported in the Federal Reserve's Flow of Funds Accounts, accentuated the bubble. Households were large net sellers of equities during these years, but life insurance companies, mutual funds, state and local government retirement funds, and bank personal trusts and estates were large net buyers. Nevertheless, the value of corporate equities directly held by the household sector more than doubled between 1994 and 1998. A balance sheet of households and nonprofit organizations shows the percentage of net worth that was directly and indirectly held as equities rose from 23% at yearend 1994 to 37% at the end of 1998; their percentage of net worth held as deposits and credit market assets fell from 21% to 16% over the same period.⁴¹ The same balance sheet shows that deposits and credit market assets as a



percentage of tangible assets fell from 50% at yearend 1994 to 47% in 1998, although deposits as a percentage of tangible assets was 31% in both 1994 and 1998, and their ratio of deposits to liabilities fell from 71% in 1994 to 63% in 1998. Clearly leverage and the risk exposure of households and nonprofit organizations rose sharply over these four years. Interest rates paid on NOW deposits and on savings and small denomination money market deposit accounts at domestic offices of all U. S. banks rose slightly between 1993 and 1998, by 30 and 29 basis points respectively, which was far less than the increase in the federal funds rate.(42)

Small depositors clearly did not benefit from the Fed's attempt to be restrictive. Interest rates on large time deposits did more or less keep pace with movements in the funds rate as did interest rates on money market mutual funds. Interest rates on loans are much more difficult to assess from the Federal Reserve's analysis of bank profitability, because so many loans are securitized and thus not on bank balance sheets and income statements. Using information from aggregate balance sheets and income statements, it appears that loan rates, net of loss provisions, were also sticky, they rose by 28 basis points between 1993 and 1998. Independently reported interest rates on consumer loans were high and relatively unchanging over these years, but independently reported interest rates on mortgage loans secured by new and secondary market houses were falling.(43) Most business loan interest rates are indexed to money market .base. rates, such as the federal funds rate, the .prime. rate, and LIBOR (London Interbank Offering Rate). They are strongly positively correlated, but the spread between a base rate and the rate charged a firm and other terms of lending are not time invariant. Trends in the fraction of loans that originate in the commercial paper market and from asset-backed issuers undoubtedly affect the cost of funds to firms, but these rates tend to move in lock step with the federal funds rate, as does the cost of the rising share of non-deposit funds that banks raise to fund loans. National income statistics on nominal after-tax corporate profits and on nominal proprietor's nonfarm income suggest that interest rates were not especially onerous; between 1993 and 1998 the former rose 49% and the latter rose 36%. Nominal national income rose 34% over the same four-year span.



The period from the collapse of Long-Term Capital Management in October 1998 to the present (August 2002) is both tortured and perhaps too recent to draw firm conclusions about what the Federal Reserve's intentions were. The monthly average federal funds rate fell from 5.51% in September to 5.07% in October to a low of 4.63% in January 1999. It averaged about 4.75% in the first half of 1999 and then began a rise of about 175 basis points until a peak of 6.54% was reached in July 2000. A Federal Reserve target level of about 6.50% was held until January 2001. Signs of an economic slowdown were evident, including those from falling stock prices; the National Bureau declared that a recession had begun in March 2001. It is arguable that this restrictive monetary policy and growing federal government surpluses precipitated the recession and successfully pricked the long-running and widely recognized stock market bubble. (44) Beginning in January 2001, the Federal Reserve reduced its target level of the federal funds rate eleven times to its present level of 1.75% and the federal budget has shifted from a large surplus to a substantial deficit.

Table 5 provides information about bank income and expenses, which supports an interpretation of the changing role of banks as intermediaries in recent years that was suggested in the preceding section. As a percentage of average consolidated assets, variations in bank net income were largely matched by accounting decisions to make provisions for losses between 1985 and 1991. During this period net interest income and net noninterest expense percentages were essentially invariant. When the Federal Reserve drove the federal funds interest rate down in 1992 and 1993, the net interest income percentage rose markedly because banks reduced the interest rates they paid on deposits more than interest rates on their loans. They managed to keep net interest income abnormally high through 1997, by not competing with deposit interest rates and allowing the share of their funds raised through deposits to decrease. Sweeping funds from transactions accounts, against which banks are required to hold idle reserves, into other liabilities allowed banks to earn interest on a larger fraction of their funds.(45) More important for changes in bank net income were two post-1993 changes, shown in the fifth and sixth columns of the table. First, the percentage average provision banks made for losses between 1994 and 2000 fell by about 50% from the average in the preceding eight years. This change is partly explained by the recovery from the 1991 recession, but also



reflects increased securitization of loans by banks. When loans are securitized without recourse, banks are not exposed to default losses. Second, net noninterest expenses as a percentage of average consolidated assets began to fall steeply. While technical improvements allowed decreased expenditures on major factors of production, most of the change in net noninterest expenses occurred because of a steep rise in other noninterest income, primarily income from securitization and fees for providing a variety of services, including credit cards and ATMs. Finally, while bank net income may gain temporarily when interest rates fall, there appears to be no long-term relation between net income, as a percentage of average consolidated assets, and the federal funds rate shown in the last column. The main conclusion about the most recent eight years is that banks are partially transforming themselves from intermediaries that have deposits, loans, and securities on their balance sheets into brokers who originate loans and then distribute them to others who acquire securitized assets. The risks of holding such assets are not borne by banks, which act as agents that provide services by collecting payments and distributing them to the holders of securitized assets for a fee. Banks are, of course, liable for misrepresentations about borrowers and for errors

Table 5
Net Income and Selected Components as a Percentage of Average Net Consolidated Assets



market assets has been decreasing since or deficiencies in providing services, but not otherwise. Data about the extent to which banks have shifted from being intermediaries to being brokers are not generally available, but as noted in the discussion of Table 4, banks' share of outstanding credit market assets has been decreasing since 1994. A different measure, the ratio of banking system credit to total debt of domestic nonfinancial sectors, was about 33% from 1965 through 1980; after 1980 this ratio declined almost monotonically to 25% in the early 1990s and then rose to about 28% in 2001. The trends in these two measures over the 1990s are not inconsistent, because financial institutions are issuing more debt that is held by other financial institutions. Neither trend implies that share of credit being originated by banks has risen or fallen.

The consequences of banks becoming brokers rather than acting as traditional intermediaries are potentially large. Additional risk is being shifted to the private sector because, while agencies of the federal government insure deposits, the government does not insure many institutional or individual holders of securitized assets. The effects of a lack of government insurance is amplified by the continuing shift of pension funds from defined-benefit to defined-contribution pension plans, because the Pension Benefit Guaranty Corporation that was established in the Employee Retirement Insurance Security Act of 1974 provides no insurance for defined-contribution plans. Credit derivatives may allow some risk to be dissipated in the private sector, but not eliminated. Most individuals will not be able to assess the extent to which their funds are protected.

The quantity and quality of information that was heretofore collected and used by banks to allocate funds and to keep informed about clients after a loan was made are also likely to diminish. Once loans are off a bank's books, the incentive for banks to stay informed falls. Further, because it will be necessary to use standardized loan agreements in order to make securitized assets comprehensible to buyers, it is less likely that nonstandard requests for loans will be honored. Banks traditionally knew their clients well enough to incorporate some specific terms in loan contracts that sometimes were crucial to the success of a borrower. Other nonbank lenders and venture capitalists may replace banks as sources of funds for such clients, but lending terms are likely to be less accommodating.



5 Europe countries

5.1 Introduction

Europe has a long history of great cultural and economic achievement, starting as far back as the Bronze Age. The origin of Western culture is generally attributed to the ancient Greeks, and the Roman Empire spanned the entire continent for many centuries. Following the decline of the Roman Empire, Europe entered a long period of stasis, generally known as the Dark Ages, which came to an end with the Renaissance and the New Monarchs, marking the start of a period of discovery, exploration, and increase in scientific knowledge. From the 15th century European nations, particularly Spain, Portugal, France, and Britain, built large colonial empires, with vast holdings in Africa, the Americas, and Asia. The Industrial Revolution started in Europe in the 18th century, leading to much greater general prosperity and a corresponding increase in population. After World War II, and until the end of the Cold War, Europe was divided into two major political and economic blocks: Communist nations in Eastern Europe and capitalistic countries in Western Europe. Around 1990 the Eastern block broke up.

Often other borders of Europe are drawn, based on political, economical, cultural or practical considerations. This has led to there being several different "Europes" that are not always identical in size, including or excluding countries dependent on the definition of "Europe" used. Increasingly, the word "Europe" is primarily being used as a synonym for the members of the European Union (EU). Fifteen European states are currently members of the EU, with 10 more due to join by mid-2004, a few more negotiating for membership and several more expected to commence negotiations at some stage in the future. Almost all European states are members of the Council of Europe; the sole exceptions are Belarus and the Vatican City.

- **Area and population of European countries**

country	pop. dens.	area	population
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	(/km ²)	(km ²)	(2002-07-01 est.)
<u>Monaco</u>	16,000	2	31,987
<u>Gibraltar (UK)</u>	5,000	6	27,714
<u>Vatican City</u>	2,000	0.44	900
<u>Malta</u>	1,260	316	397,499
<u>Guernsey (UK)</u>	830	78	64,587
<u>Jersey (UK)</u>	774	116	89,775
<u>San Marino</u>	455	61	27,730
<u>Netherlands</u>	387	41,526	16,067,754
<u>Belgium</u>	337	30,510	10,274,595
<u>United Kingdom</u>	244	244,820	59,778,002
<u>Germany</u>	233	357,021	83,251,851
<u>Liechtenstein</u>	205	160	32,842
<u>Italy</u>	192	301,230	57,715,625
<u>Switzerland</u>	177	41,290	7,301,994
<u>Luxembourg</u>	173	2,586	448,569
<u>Andorra</u>	146	468	68,403
<u>Moldova</u>	131	33,843	4,434,547
<u>Czech Republic</u>	130	78,866	10,256,760
<u>Isle of Man (UK)</u>	129	572	73,873
<u>Denmark</u>	125	43,094	5,368,854
<u>Poland</u>	124	312,685	38,625,478
<u>Albania</u>	123	28,748	3,544,841
<u>Armenia</u>	112	29,800	3,330,099
<u>Slovakia</u>	111	48,845	5,422,366
<u>Serbia</u>	110	88,361	9,780,000
<u>France</u>	109	547,030	59,765,983
<u>Portugal</u>	109	92,391	10,084,245
<u>Hungary</u>	108	93,030	10,075,034
<u>Austria</u>	97	83,858	8,169,929
<u>Slovenia</u>	95	20,273	1,932,917
<u>Romania</u>	91	238,391	21,698,181
<u>Azerbaijan</u>	90	86,600	7,798,497
<u>Turkey</u>	86	780,580	67,308,928
<u>Cyprus</u>	83	9,250	767,314
<u>Republic of Macedonia</u>	81	25,333	2,054,800
<u>Greece</u>	81	131,940	10,645,343
<u>Ukraine</u>	80	603,700	48,396,470
<u>Spain</u>	79	504,782	40,077,100
<u>Croatia</u>	78	56,542	4,390,751
<u>Bosnia and Herzegovina</u>	78	51,129	3,964,388
<u>Georgia</u>	71	69,700	4,960,951
<u>Bulgaria</u>	69	110,910	7,621,337
<u>Republic of Ireland</u>	55	70,280	3,883,159
<u>Lithuania</u>	55	65,200	3,601,138
<u>Belarus</u>	50	207,600	10,335,382



<u>Latvia</u>	37	64,589	2,366,515
<u>Montenegro</u>	36	13,812	500,000
<u>Faroe Islands (Denm.)</u>	33	1,399	46,011
<u>Estonia</u>	31	45,226	1,415,681
<u>Sweden</u>	20	449,964	8,876,744
<u>Finland</u>	15	337,030	5,183,545
<u>Norway</u>	14	324,220	4,525,116
<u>Russia</u>	8.5	17,075,200	144,978,573
<u>Iceland</u>	2.7	103,000	279,384
<u>Svalbard (Norw.)</u>	0.05	62,049	2,868

• Area

Area in square kilometres, 2002

Ran k	Country	Area (km²)
1	Russia	<u>17,075,200</u>
2	Greenland	<u>2,166,086</u>
3	Turkey	<u>780,580</u>
4	Ukraine	<u>603,700</u>
5	France	<u>547,030</u>
6	Spain	<u>504,782</u>
7	Sweden	<u>449,964</u>
8	Germany	<u>357,021</u>
9	Finland	<u>337,030</u>
10	Norway	<u>324,220</u>
11	Poland	<u>312,685</u>
12	Italy	<u>301,230</u>
13	United Kingdom	<u>244,820</u>
14	Romania	<u>237,500</u>
15	Belarus	<u>207,600</u>
16	Greece	<u>131,940</u>
17	Bulgaria	<u>110,910</u>
18	Iceland	<u>103,000</u>
19	Serbia and Montenegro	<u>102,350</u>
20	Hungary	<u>93,030</u>
21	Portugal	<u>92,391</u>
22	Austria	<u>83,858</u>



23	Czech Republic	78,866
24	Ireland	70,280
25	Lithuania	65,200
26	Latvia	64,589
27	Croatia	56,542
28	Bosnia and Herzegovina	51,129
29	Slovakia	48,845
30	Estonia	45,226
31	Denmark	43,094
32	Netherlands	41,526
33	Switzerland	41,290
34	Moldova	33,843
35	Belgium	30,510
36	Albania	28,748
37	Macedonia (FYROM)	25,333
38	Slovenia	20,273
39	Cyprus	9,250
40	Luxembourg	2,586
41	Faroe Islands	1,399
42	Malta	316
43	Liechtenstein	160
44	San Marino	61
45	Monaco	2
46	Vatican City	0.44
	<i>Average</i>	<u>563,614</u>
	<i>Average without Russia and Greenland</i>	<u>151,931</u>
	<i>Median</i>	<u>74,573</u>

6 BANKING AND FINANCE SYSTEM CONVERGENCE IN EUROPE

This paper implements (GENERAL MEMBERSHIP MEETING) GMM estimation of a dynamic fixed effects model to determine whether there has been a shift towards convergence of the banking systems in Europe, following the European Union (EU) single market launched in January 1993 and the recent restructuring of banking

systems in the transition economies. Evidence of convergence is of considerable importance in gauging the effects of changes in interest rates given the relative importance of banking sectors, relative to capital markets in continental European economies and thus of the credit channel for the monetary transmission mechanism in Europe. The model is estimated and tested, firstly for a homogenous panel of Central and Eastern Europe transition economies, and secondly for a panel of the transition economies jointly with the EU. The evidence suggests that the banking systems of the transition economies have converged only in certain key aspects of their intermediation roles, but the overall convergence is yet to be achieved. This may reflect different rates of progress in developing alternative (to bank) savings instruments. With respect to the larger panel that encompasses transitional economies as well as the EU, convergence of the banking systems is only found in terms of loans to the private sector rather than the government sector. These results emphasize the differences in the role of bank loans to government in this group of countries; the banking systems have yet to achieve convergence in that respect, but this may also reflect lack of progress with fiscal deficit reduction in transition economies relative to that achieved, post-Maastricht, in the EU and relative lack of progress with respect to developing domestic government bond markets as an alternative to bank finance.

Overall, the results imply that the banking systems of the transition economies have Converged only on the EU model in certain key aspects of their intermediation roles, While overall convergence is yet to be achieved especially in terms of bank loans to government as well as the mobilization of time and savings deposits. Most policy makers and academics agree that the restructuring of the financial system is an integral element of the ongoing economic transformation in Eastern and Central Europe (Mullineux, 1998; Walter, 1998). This is particularly important because, as Doukas, Murinde and Wihlborg (1998) have observed, one distinct feature which all transition economies had in common during the central planning era was that a market oriented financial system was almost completely absent. Apart from some informal financing activities, the financial sector comprised a “monobank system” (state bank, savings banks, specialized banks, etc.) which played a limited role compared to a traditional banking system (Buch, 1996). Although the savings banks accepted deposits from

households and the state banks had accounting and credit disbursement roles, the final decisions on the distribution of credit rested with the central planning agencies, which allocated credit to selected enterprises in order to attain output targets. Bank managers had no incentive to undertake credit risk analysis because the credit lines were underwritten by the state; moreover, the managers were not constrained by capital

budgeting criteria (e.g. using financial ratios to analyze the efficiency of investment). At the genesis of the transition period, there was no blueprint for developing a banking sector (Bahra, Green and Murinde, 1997). However, most transition economies started by creating a two-tier banking system, comprising on the one hand a central bank to oversee monetary policy and bank supervision, and on the other hand some commercial banks to perform some form of financial intermediation. Thereafter, the process of privatisation of all or some of the existing banks and new entry was used to encourage further the development of the commercial banking system. However, as private banks started to operate on the basis of market criteria and as privatisation of firms increased, there was a marked increase in the amount of credit default. Clearly, the inherited bad loans problem affected almost every transition economy, but in some cases the accumulation of bad loans by the banking sector became an epidemic (Buch, 1996). It is useful to note, therefore, that although the banking systems of these transition economies shared a broadly common central planning heritage, they have had different experiences of bank development during the transition process, and also inherited different levels of bad loans from the previous period of directed lending (Buch, 1996). The procedures for dealing with the inherited bad loans also varied considerably across the transition economies (Buch, 1996; Mullineux, 1998). Consequently, the banks have grown at very different rates throughout the 1980s such that by 1993 (as we explain in Section 2) there were marked differences in the level of bank development in each of the transition economies. Since January 1993, when the EU launched the European single market, the transition economies have more purposely redefined their reforms, especially with the banking sector, in order to prepare for subsequent entry to the EU as members. This paper investigates whether there has been some convergence in the banking systems of transition economies in terms of a systematic shift in the output of banking operations in these economies, taking January 1993 as the initial conditions period. In addition to

shedding light on the growth behavior of the banking sectors in these economies, the paper is motivated by the fact that one of the main expectations of transition economies was that the launching of a single market in Europe in January 1993 would impact positively on their budding financial systems by facilitating their future membership. In contrast to the literature on economic growth models (e.g. Sala-i- Martin, 1996) where convergence is tested with respect to the growth rate of national output, the paper re-interprets the convergence tests for banking systems with respect to the growth rates of bank output. It thus follows the literature on the cost and output behavior of banks, relating to economies of scale and scope.

In the paper, econometric tests for convergence are conducted in two steps. In the first step, the idea of absolute convergence used in the literature on economic growth (e.g. Barro and Xala-i-Martin, 1995) is adopted in order to consider a group of transition economies which are assumed to have structurally similar banking systems; the only difference among the banking systems is the initial quantity of bank output as at 1993. In other words, a relatively homogenous group of transition economies is used to test for convergence of the banking systems across these economies. The econometric test for convergence used here underpins the concept of convergence that banking systems with lower bank output (*i.e.* loans), expressed relative to their steady-state levels at 1993, tend to grow faster; over time, 1993 to 1997, the bank output growth rates across all the transition economies tend to converge, suggesting that the banking systems are converging. In the second step, the idea of absolute convergence is maintained but two groups of economies are distinguished, namely the transition economies on the one hand and the EU countries on the other. The banking systems in these two groups of economies have different starting values at the initial period 1993; the transition economies have low initial values of bank output, while the EU countries have high initial values of bank output. Since each of the banking systems have some similar underlying features, the growth rate of bank output in the transition economies is larger, given the lower initial value (at 1993). This implies that convergence takes place in the sense that transition economies have lower starting values of bank output and higher bank output growth rates, and these tend to catch up or converge to those the EU. In both the first and second steps, the loan activities of banks, which tie down the product (output) of



banking operations, are disaggregated into three tiers: loans to the private sector, loans to public enterprises and loans to government sector. The analysis also draws from the literature which addresses the main controversy of defining output in a banking firm (Murinde, 1992). This literature argues that deposits may be regarded as bank output. In this case, the convergence test is applied to determine if there has been a shift towards a sustained increase in bank output (this time defined by deposits), given an initial level, in a manner that suggests that the banking systems are converging. Hence the convergence tests will also shed light on whether the banking systems are converging on the supply-side (loans) or on the demand side (deposits), or both. The paper makes at least four major contributions. First, it proposes and implements a novel application of convergence tests with respect to the banking systems of transition economies, among themselves and on the EU. Second, it covers the period (1993-97) in which there has been substantial financial innovation, liberalisation and regulatory reform in the transition economies as well as the EU member countries which the transition countries aspire to join in due course. Third, the paper yields evidence which complements the experience of the genesis and later developments in the banking systems of the transition economies detailed below. Two main conclusions emerge: it is shown that in the transition economies, and for most of the period 1993-97, the banking systems of Central and Eastern Europe exhibited convergence in terms of their loan portfolio to the private sector and the government sector, but not the public enterprises; it is also found that these banking systems also exhibit convergence in terms of their liabilities in terms of demand deposits as well as foreign liabilities, but not time and saving deposits. Taking both the results on the demand supply sides of banking operations, the findings emphasize some reasonable degree of convergence among the banking systems of the transition economies in Central and Eastern Europe. Finally, the paper makes a contribution to the analysis of the evolution of monetary policy in an expanding European Union. Evidence of convergence is of considerable importance in gauging the effects of changes in interest rates given the relative importance of banking sectors, relative to capital markets, in continental European economies and thus of the credit channel for the monetary transmission mechanism in Europe.



7 The Experience with Banking Sector Restructuring in Transition Economies

As noted in Mullineux (1998), it has become increasingly evident that the restructuring of the banking sector should be given a very high priority in the stabilisation and restructuring of formerly centrally planned economies. The increasing amount of funding allocated by development banks, such as the World Bank (IBRD) and the European Bank for Reconstruction and Development (EBRD), for the purpose of recapitalising and privatising banks, resolving bank debt problems and sponsoring the transfer of banking “know-how”, bears witness to this, as does the prominence given to banking sector reform in more recent International Monetary Fund (IMF) programmes. At the outset of the transition, the centrally planned economies had extremely rudimentary financial systems which had only recently been transformed, from the Soviet “mono-banking” model, to a “two-tier” banking system. They had only just begun to develop a third tier of co-operative and private sector banks, which were often joint ventures with “western” banks. Apart from such banks the financial sector was extremely underdeveloped. There were no capital markets or wholesale money and inter bank markets of any significance and few non-bank financial intermediaries, such as insurance companies and pension funds, managing portfolios of shares in private companies and holding government debt (bonds). This was because, at the beginning of the transition and before the launch of privatisation programmes, the industrial and retailing sectors were state-owned, the service and welfare sector was underdeveloped, and tax revenue was derived largely from enterprises.

In the second half of the 1980s, first Hungary, then Bulgaria and then other transition economies took on board the “two-tier” model and they tried to find a “third-way” by introducing market forces into a central planning framework. Hungary went further by granting licenses to joint ventures between the newly created commercial banks and foreign banks. This move was followed in some other transition economies, including the then Soviet Union, which also began to allow the establishment of numerous co-operative banks, and a third tier of banks was created.



The development of this third-tier accelerated with the establishment of numerous domestically-owned private sector commercial banks following the collapse of communism in Central and Eastern Europe in 1989. The state-owned commercial banks, however, continued to dominate the banking systems in the transition economies, and privatisation of the state-owned commercial banks only gathered pace in the mid 1990s. Poland has now privatised a number of major banks with the financial support of the EBRD and Hungary has also made significant progress in this area, also with the EBRD's financial assistance. But privatisation also recently gathered pace in the Czech Republic. It should be noted that the "mono-bank" system was always a misnomer since most of these economies had a number of specialised (for example, investment, agricultural, and trade finance) banks, as well a national bank and also a savings bank, whose degree of independence from the national bank varied. When "two-tier" banking was introduced, not only were new commercial banks created, but the specialised and savings banks were usually also permitted to undertake commercial banking business. The new commercial banks were often regionally based (as in Poland) or allocated SOEs on an industrial sectoral basis (as in Bulgaria), which led to a degree of de facto regional concentration. In Poland, for example, nine regional state-owned banks (SOBs) were established alongside a number of formerly specialised banks.

At the time of their creation, the commercial banks clearly lacked experienced staff with well developed lending (risk appraisal) skills, as well as the facilities to collect deposits from the public and to provide modern money transmission services. The general public was used to receiving rudimentary services from the state savings banks; whose key function was to collect savings and channel them, via the national banks, to help fund planned expenditure. Under "monobanking", the national banks' roles included the disbursement of planned budgetary allocations, the collection of taxes, and monitoring the use of the allocated credits (i.e. a governance role). It was thus an arm of the planning agency, the finance ministry, and a central bank rolled into one.

The abandonment of central planning in favor of "capitalism" requires the introduction of an alternative means of allocating "credits", or "capital". In capitalist



countries the banks are by far the most important locators of “capital” through the advancement of loans (debt contracts) to enterprises and households. In some capitalist economies “capital markets” (stock exchanges) also play an important, but normally subservant, role in the allocation of capital (see Doukas, Murinde and Wihlborg, 1998). These markets allocate debt and equity capital directly to enterprises, who issue securities such as bonds and “shares”, without the use of an intermediary such as a bank. The proportion of capital allocated this way has grown significantly over the last two decades as a result of “securitisation” involving “disintermediation”. We need not enter here into the reasons for this development, but can note that it is only in the US that the future role of banks has, prematurely and due to special factors prevailing in the late 1980s and early 1990s (in our view), been seriously called into question by some commentators. It seems likely that, due to information asymmetry, banks will remain the main source of finance for small and medium sized enterprises (SMEs) for the foreseeable future (even in the US). It is only in countries at an advanced stage of financial development that capital markets, rather than banks, play significant role in allocating capital and it should be noted that these markets satisfy the debt and equity needs of only the larger enterprises. The focus of financial sector reform in transforming economies should therefore be to first establish a well functioning banking sector and then, subsequently, to develop capital markets. The latter will anyway begin to develop as a result of the execution of privatisation programmes and the issuance of government securities (treasury bills and bonds). The restructuring of the banking sector does, however, require the development of wholesale money markets, including an interbank market.

These markets facilitate increased efficiency in the allocation of capital by banks which is the prime goal of the reform process. This is because banks with insufficient profitable lending opportunities and a surplus of (retail) deposits should be able to lend to banks in the opposite position. It is also evident that a rapid transfer of know-how (To practitioners and supervisors) concerning lending techniques and risk control, via asset and liability management, in commercial banking is required if a more efficient allocation of capital is to be achieved. In capitalist economies, the financial sector not only allocates capital but also monitors its use and imposes sanctions on its misuse. This latter “corporate governance” function is crucial since if capital, once allocated, is not



efficiently used, then it should be withdrawn and re-allocated. It is through this process that continuous restructuring and development occurs under capitalism. For the process to work effectively a legal system has to be developed covering property rights, privatisation and restitution, debt and equity contracts.

8 Europe market

Despite the implementation of the Common Market, European economic integration still remained unachieved in the mid-1980s. The "costs of Non-Europe" were addressed in the White Paper of 1985, proposing some 300 measures to promote the liberalisation of trade in goods and services and of factor movements, such as the cancellation of border formalities and non tariff barriers having survived the Common market, the liberalisation of public procurement practices, the mutual recognition of technical standards, and financial integration and regulation, the free movement of citizens. Ex ante studies -synthesised in the Cecchini report- suggested that the Single Market would tend to lower prices through increased competition, induce market structure transformations, and foster a concentration of resources in more efficient uses. These effects would translate into sizeable welfare gains, increases in GDP, and increased competitiveness vis-à-vis non-member countries.

Even if trade per se was not the core of ex ante studies, the implicit assumption was that trade liberalisation would translate into an increase in trade flows within the Community, and that most of this increase would be intra-industry trade (IIT), i.e. simultaneous exports and imports within the same industries. Adjustment costs in that case are generally considered to be much smaller than those associated with an inter-industry specialisation driving towards a concentration of economic activity on a limited number of industries and the abandon of others. This optimistic reasoning was built upon the experience of the implementation of the Common Market: contrasting with the conclusions of a traditional theory of international trade linking integration and inter-industry trade, the European integration was accompanied by a sharp increase in intra-industry trade.



New developments in international trade theory, such as agglomeration economies or the vertical differentiation of products need to be taken into account when assessing the Single market and giving an overview of intra-European trade patterns. Bilateral intra-European trade flow statistics for some 10,000 products are used in order to break down trade into three categories: inter industry trade, intra-industry trade in horizontally differentiated products and, finally, intra-industry trade in vertically differentiated products (products of different quality). As expected, intra-industry trade has increased since the mid-1980s: thus, on the whole, this evidence does not support a possible scenario of concentration of industries in a limited number of countries. Contrasting with the conclusions of *ex ante* studies, the share of intra-industry trade of varieties has remained remarkably stable over time, whereas the share of intra-industry trade of qualities has increased rapidly, and is now the most important trade type in intra-European trade. As a result, the deep integration of European economies has not so far implied deep specialisation. Spain and Portugal have successfully managed their openness to European competition withdrawing from a scheme of residual specialisation in those (labour intensive) activities abandoned by the core countries. Nevertheless the importance of intra-industry trade in qualities, and not in varieties, suggests a qualitative division of labour within the community. Adjustments are taking place within industries along the quality spectrum, rather than between industries. The increase in intra-industry trade is the result of numerous determinants, here identified using an econometric model having four dimensions (country, partner, industry, time) and combining explanatory variables on country characteristics (comparative advantage, size etc.), market structure (returns to scale, product differentiation), and European integration (non tariff barriers for example). One of the main conclusion is that the share of IIT in vertically differentiated products increases with the economic distance between countries, a result so far rather associated to inter-industry trade. This suggests that the adjustment costs associated with intra-industry trade in vertically differentiated products. The Single market in itself has only had a limited direct impact on this evolution of intra-EC trade patterns. The cancellation of boarder formalities represents a visible shock, reinforcing the more general trend of decreasing transaction costs pushing towards IIT. In



contrast, the cancellation of non tariff barriers seems to favour inter-industry trade, possibly revigorating the specialisation process among member countries. Finally - despite evidence for industries like chemicals and automobiles- there is no evidence of generalised agglomeration economies potentially fuelling asymmetries among member states. In total, more general determinants are at work. For example, the market size favours more variety as well as a larger quality spectrum, especially for rich countries. Returns to scale also lead to a higher share of IIT, a phenomenon reinforced by the wave of intra-European mergers and acquisitions. These factors, which may be indirectly associated to the Single market, have thus contributed to reinforce the intra-industry nature of intra-EC trade.

Thus, so far, the first years of the Single market have neither validated the optimistic scenario entailed in ex ante studies, nor led to a more pronounced specialisation of European members potentially associated with cohesion costs. Adjustments have taken place within industries, on the quality spectrum. This suggests that a qualitative division of labour has emerged in Europe, in which countries as different as Ireland (due to inward foreign direct investment) and Germany are specialised on up-market products, whereas Southern member states are specialised on the low and medium quality.



9 Conclusion

The main finding of this study is the confirmation that U.S are the most advanced technological country in the world, a big increase has been realized in its technology and economic sectors after the second world war, and last worthy to note indicator were from 1994-2000, and now it started to raise up by its economy once again.

Cultural language is a basic element in evaluating how much respectful is the other side respecting you, even though its different from society to another, but still there should is certain rules which can be followed as an international ones .U.S with its wealth of natural resources, integrated and largely self-contained economy, political stability and free market system has the most powerful, diverse, and technologically advanced economy in the world, and it is an attractive place for foreign investors especially British ones.

European countries has a long history which is filled of great increases with success, and decreases as well, nevertheless it took a great step toward improvement after the second world war in the industrialize age, Europe was divided into two major political and economic blocks : Communist nations (Eastern Europe), and Capitalistic countries (East Europe) until the end of the cold war, European union consists of fifteen member countries, with 10 more due to join by mid-2004.Also the share of Intra-Industry Trade IIT in vertically differentiated products increases with the economic distance between countries, it has increased since the mid-1980s, and adjustments have taken a big place within industries, on the quality spectrum. and they have a good market because they are selling to the all world almost .and it help them more when the get to European Union cause there is no tax between them and they could open companies now in all Europe easy and made a new investments in Europe specially with Eastern Europe .

And after my study about banking and finance for US and Europe I found that US have more and fast develop finance than Europe but the finance of Europe growing also fast not like US but one day they will be in the same level and maybe more .



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