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Alexis Drach and Youssef Cassis, *Financial Deregulation: A Historical Perspective*

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Charles Goodhart*

This is a book of essays about the financial regulatory changes that took place in the advanced economies of Western Europe in the three decades, 1970-2000, also including chapters on the USA and Japan, and a final chapter/essay on 'EU Bank Regulation after the Great Financial Crisis'. These essays are mostly about changes to bank regulations, but there is also, in some of them, some usually rather brief discussion of the regulatory reform to the capital market. There are specific Chapters on the UK, the EU, Germany, France and Italy, but nothing on Scandinavia, emerging economies, e.g. Latin America, or Communist countries. The two editors, Drach and Cassis, are EU focussed, and I found their contributions, the 'Foreword' by Cassis, (vi-x), the 'Introduction', (1-23), and Chapter 5 on 'The European Way to Deregulation', by Drach, to be the most instructive parts of the book. They are formidably well read in this field.

There is, however, a semantic problem with this study, emphasized by its title. This is that 'deregulation' means, at least to me, the removal of *rules* of behaviour. It was not so much general rules, but direct *constraints* on banking activity, e.g. direct controls over the amount and direction of bank lending, direct controls over the interest rates that banks (and non-bank financial intermediaries, such as S&Ls and Building Societies) could charge, that were removed in the 1970s and 1980s. Certainly, there was 'liberalisation', but it is moot whether you could call it 'deregulation'.

The constraints on banks had coincided with, and perhaps been quite largely responsible for, a period, 1935-1970, in which there had hardly been *any* bank failures or financial stability crises. By the late 1960s one of the reasons for the controls imposed in the 1930s, the view

*London School of Economics. C.A.Goodhart@lse.ac.uk

that excess competition led to falling profits and hence a reach for risky yield, had fallen out of favour. Instead, the inefficiencies and myriad complications of such direct-control systems were more immediately felt both by the banks and the authorities. But after nearly forty years of banking stability, no one really knew how a more liberalised system would work. In practice, therefore, the extent to which liberalisation might lead to periods of financial/banking instability was not foreseen, and the immediate imposition of regulatory rules, especially on capital, were insufficiently tough.

Back in the 1960s, the only regulations in the UK were on cash and liquidity ratios; indeed bank capital issues had also at times been constrained and limited. But with the development of wholesale markets, especially the euro-dollar market, any liquidity constrained bank, whose solvency was unimpeachable, could borrow money in such wholesale markets. As a result, in the 1970s regulation switched from a liquidity to a capital focus, a point not sufficiently captured in most of these essays, with hardly any reference made to the euro-dollar market.

Probably the most important financial constraint of all in the post-WWII period was exchange control over international capital flows. Once this was removed countries could no longer successfully impose the prior direct controls on their own banks, since this could be easily avoided, e.g. by borrowing abroad and returning those funds to one's home country. Thus, when exchange controls were abandoned in the UK by the incoming Conservative government, in one swoop, in 1979, the direct control then in place, (the Corset, whose characteristics I had invented earlier in the 1970s) had to be abandoned, (thereby leading to a surge in the money supply, thoroughly disrupting the government's Medium Term Financial Strategy).

Moreover, the shift from exchange controls to a much freer market system allowed cross-border banking, via subsidiaries and branches, reinforced both by political developments, especially in the EU, which is well recorded in Chapter 5 and 9, and by technological developments, e.g. greater ease of international communication. What is less well reported is that much of the cross-border banking became done by US banks, and their entry into other countries influenced regulatory practice there—though this is correctly noted in Chapter 4 on Japan. To take one example, it had been the practice in the UK for the Bank of England to call on the main commercial banks to participate in transferring funds to a local bank in difficulties, but the incoming US banks refused to take part, pushing the need for bail-out then entirely back onto the Bank of England and the taxpayer.

In his Foreword, Youssef Cassis asks whether the period 1970-1990 can reasonably be viewed as representing a swing of a continuing, longer-term, regulatory cycle, in this case towards deregulation. Rightly, in my view, he, and later Forrest Capie, are rather sceptical of this concept. Prior to the regulations, which began to be imposed in the 1970s, there had hardly been any rules of conduct, or supervision over commercial banks. The structure of banking had been liberalised in the latter part of the 19th century, particularly the move from unlimited to limited liability and the development of large joint-stock banks, whether universal banks as in Germany, or narrower deposit banks, as in Britain and France. But the central bank had only very limited direct powers over the large commercial banks, focussing its regulation much more on the quality of the collateral of the assets placed with them. Moreover, outside of the USA, it was not so much the Depression that led governments to control the direction of resource usage and financial flows, but rather WWII. The exigencies of wartime led European countries to shift to direct controls over most aspects of the economy, including banking, rather than allowing free market mechanisms to remain.

At the beginning of the period covered by the book, around and before 1970, the staff employed by the Bank of England to provide direct information on, and supervision of, the wider banking system amounted to no more than about four or five people, being the Principal of the Discount Office, and his three or four staff members. By the end of the period covered in the book, the supervisory staff, applying such oversight, had become one of the larger Divisions of the Bank, known as The Bank and Money Market Supervisory Department, or BAMMS. I cannot remember exactly how many staff it had by 1990, but I would guess that it was probably over one hundred. One can hardly call such a massive increase in supervision and regulation a feature of financial deregulation.

For such reasons, I would much rather that the title of the book had been changed to something like 'Financial Liberalisation Offset by Greater Regulation and Supervision', but that quibble does not do justice to the considerable quality of the historical record of the regulatory changes made in the countries included in this book. For those wanting to know what regulatory changes took place in these countries during these years, this book will be an extremely valuable source. The individual Chapters are generally well written, providing much information, and, as far as I know, accurate.

That said, the removal of exchange controls, and with it the greater adoption of cross-border banking, did mean that there became a growing need for international cooperation between the regulatory authorities in all these various countries. The Chapters, good though they are, largely take the form of country silos, whereas much of the activity took place through the Basel Committee on Banking Supervision, whose history during these decades I have covered myself separately.