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Global Crisis and Financial Regulations: Who Determines What? Cross-Country Analysis of China, Germany, Japan, UK, and USA

Cover Page Note

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1. Introduction

"To better understand the determinants of bank regulatory and supervisory policies and effective strategies for reforming those policies, future research should use case studies to trace the forces shaping the evolution of bank regulations and supervision."[1]

Regardless of the exceptionally deep recession that the financial meltdown brought about, the Great Recession has not been extraordinary.[2] On the contrary, as the current crisis fundamentally originates from past decisions arguably tracing back for decades, all of the five economies concerned in this paper (UK, USA, Germany, Japan, and China), have a significant share in both triggering as well as exacerbating the current downturn.

Subsequently, although it would be wrong to consider the Great Recession unique per se, the global financial crisis has nevertheless emphasized that the domestic economies affect each-other on a greater scale than ever before. At the same time, since the focus of this paper is on international financial regulations, the increasing inability to differentiate between the domestic and international economic variables, directly relates to the core of this paper.

The numerous intergovernmental organizations such as the IMF, WTO, WB, OSCDE, and some regulatory initiatives (e.g. Basel Accord, IOSCO, IAIS)[3] have not proven efficient enough. Mainly since their actual options are ultimately limited to the governments' individual interests. While observing the G20 economies, the countries seem to have agreed that financial regulations are the source of mutual interest.[4] Nevertheless, while looking at the policy outcomes, the cooperative atmosphere fades once compromises need decisive finalization. Therefore, several questions spark. Are the real economic interests genuinely mutual? And if not, does the economic *status quo* incentivize the creation of enhanced international financial regulations?

1.1 Research Design

The goal of this paper is to examine, whether the economic *status quo* incentivizes the creation of enhanced international financial regulations. Explicitly, five countries are studied: UK, USA, Germany, Japan, and China. While analyzing the crisis' implications, the countries will be observed in pre- and post-crisis settings.

While inspired by Barth, Caprio, and Levine, who see case studies as the best option for answering similar questions, this paper has chosen to study the

[1] Barth, J. R., Caprio, G., and Levine, R. (2006).
[2] See, for example: Bank of England (November 2009); The Warwick Commission (2009); Cohen, B. J. (2008); Nesvetailova A. (2008); and Wolf, M. (2008).
[3] Kerwer, D. (2005), p. 615.
[4] See, for example: Myung-bak, L (January 2010); Monck, A. (January 2010).

macro economic conditions of UK, USA, Germany, Japan, and China. First, after a brief literature review on generic trends in international financial regulations and an outline of research design, an assessment of the respective countries' macro-economic conditions is provided. Next, dependent on the respective economies' financial market structures, countries are divided into three groups: 1) Market-based United Kingdom and United States; 2) Bank-based Germany and Japan; 3) Quasi-communist China. While using the groups for structured comparisons, three broad categories are chosen as gateways:

1) Regulatory reform. Herein, the countries' recent regulatory reforms will be observed, whereas emphasis will be placed on the internationally significant aspects of the reforms. The timeframe of the studied reforms depends on a country, but the study of past reforms does generally not date back more than twenty five years.

2) An internationally distinguishing variable. This category was chosen to bring out the different characteristics that the observed countries uniquely exhibit. As with the regulatory reform, the main criteria while choosing the respective denominators, has been the denominator's relative importance for international financial regulations.

3) Post-Crisis conditions. This section is an assessment of the respective countries' economic conditions after the Great Recession.

Ultimately, since the over-arching research question is whether the economic *status quo* incentivizes the creation of enhanced international financial regulations, the comparative assessment of the five economies is expected to offer better clarity for this matter. However, it must be noted that the paper does not claim to depict the entire range of denominators influencing the international financial system. Instead, while studying the economic determinants of the five economies, potential international challenges are identified, whereas the domestic leaderships' genuine interest in a global resolution is studied.

Thus, an over-arching research-question prevails: does the economic *status quo* incentivize the creation of enhanced international financial regulations?

1.2 Generic Trends in International Financial Regulations

The recent study by Bank of England concludes that "financial crisis has demonstrated the need for change" in the regulatory framework.[5] Separately from the Bank of England, the arguments are supported by A. Baker, who argues that "renovating the concept of transgovernmentalism brings the participatory deficits in the current global financial architecture into sharp

[5] Bank of England (2009), p. 3.

focus and points us in the direction of workable reform agenda that would expand inclusion and participation."[6]

Since the renovation of "transgovernmentalism" with regard to financial regulations purports enhanced coordination over regulatory measures, the crisis has certainly prepared the international stage for potential reforms. However, what is the actual financial architecture that demands redefined international cooperation? The literature suggests different interpretations.

First, a traditional market-oriented approach divides the financial sector into three branches: banks, insurance, and securities' industry.[7] Herein, since the traditional division may not always accurately depict the structure of the modern financial industry, the recent literature tends to interpret the categories within a single framework, whereas the regulators arguably have failed to flexibly address the trend of convergence of the three branches.

E.g. D. A. Singer considers such a failure as the main source of inadequate regulations- namely due to "asymmetric information" gathering, which so far has mostly been concerned with the banking sector.[8] Furthermore, as Singer points out, since regulators are looking for "win-sets"- the conditions, where regulations are seen effective enough for guaranteeing stability- they are unlikely to adequately address the potential "information asymmetries" as long as there is no direct pressure from the markets. Furthermore, this is both true domestically as well for international regulators.

From an international perspective, the regulators' bias towards "win-sets" may cause regulatory "races to the bottom." Singer brings the example of the rise of Japanese banks in the 1980s, when relatively lax regulations on Japanese banks created exogenous shocks, which in turn shifted the foreign regulators' "win-sets" from their initial equilibriums, and thus created global pressures for deregulation.[9] With regard to analyzing the regulatory fallacies that fed the creation of the recent meltdown, similar trends are noted.

A. Nesvetailova argues that the public policy authorities "lost track of the real effects of financial deregulation" as the dominant criteria was to beat the competing markets with deregulation.[10] Moreover, from the perspective of appropriate risk assessment, the information asymmetries impose another relevant shortfall. As Warwick Commission points out, the misconception that risk is solely "inherent in the characteristics of an asset or financial instrument" distorts the real picture, where credit, liquidity, and over-all market conditions may pose considerable risk. Since "different parts of the financial system have different capacities to hedge each type of risk", the regulators often fail to preemptively address potential dangers within innovative instruments- such as it was the case with the MBSs in 2007.[11]

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[6] Baker, A. (2009), p. 195.
[7] Singer, D. A. (2007), p. 10.
[8] Singer, D. A. (2007), p. 13.
[9] Singer, D. A. (2007), p. 27.
[10] Nesvetailova A. (2008), p. 85.
[11] The Warwick Commission (2009), p. 4.

N. Penny, while having a somewhat different focus, elaborates on the effect of high long-term interest rates, and disproportionately lax regulations of hedge funds. Again, since regulators' unfortunate overemphasis of the banking sector has left the other financial institutions without reasonable supervision, the actual causes of crisis as argued by Penny- hedge funds- have repeatedly failed to "redeem some of the securities they had issued, which quickly led to global liquidity crisis."[12] As Penny points out, the recent MBS' triggered crisis was not the first time, when hedge funds where the main sources of problem- so was the case with the 1998 bankruptcy of Long Term Capital Management, which according to Penny, had "the potential to destabilize the capital markets on a global scale."[13] Therefore, as the structural regulatory fallacies have been a long-term problem, it provides clear evidence for the regulators' relative passiveness as long as their "win-set" is not in direct danger.

For example, while briefly elaborating on some of the most important international regulatory initiatives affecting the financial industry, the Basel Accord stands out. After being introduced at the end of the 1980s, it quickly became one of the most important international regulatory initiatives- mostly due to the fact that it acquired the image as a "reputational mechanism."[14] Today, despite the talks for implementing Basel III, most of the core requirements are still defined by Basel II (initially published in 2004), which from the regulatory perspective, focuses mostly on "pro-cyclical regulation."[15] As argued by A. Korinek, however, since the pro-cyclical measures have failed to prevent the banks from excessive risk taking, the Basel Accord has not functioned efficiently.[16]

Nevertheless, with regard to the initial accord, a more positive tone still prevails. For instance, a study observing the correlation between Effective Banking Supervision (BCP) and the banking sectors' performance in 65 countries from 1998 to 2002- time, when most of the Basel I was still effective- found "a direct positive effect of compliance with the BCP on banking sector performance."[17] Thus, although the pro-cyclical deregulation implemented by Basel II throughout the boom years proved to mislead the banking industry, the effectiveness of most of the Basel I measures provides a reasonably promising outlook for the Basel III as it is drafted.

With regard to insurance and securities' industries, there almost are no extensive initiatives for international regulations. As Singer points out the paradox of "information asymmetry" in financial regulations, he also notes that the relevant international regulatory institutions for insurance- and securities' markets (IAIS, and IOSCO) are mostly marginal compared to the

[12] Penny, N. (2008), p. 25.
[13] Penny, N. (2008), p. 19.
[14] Ho, D. E. (2002).
[15] See, for example: Korinek, A. et al. (May 2009).
[16] Korinek, A. (2009), p. 20.
[17] Podpiera, R. (2006).

relevance of the Basel Accord.[18] Hence, just as on domestic levels, the insurance- and securities-markets are often left without adequate attention, a similar fallacy is reflected on the international regulatory arena.

In the following sections, five economies have chosen to be observed more closely. From the perspective of UK, USA, Germany, Japan, and China, the cross-country study will aim to go beyond the generics of international financial regulations. Ultimately, after assessing the over-all macro-economic conditions, and considering the five economies separately, the central research question will be aimed to have more comprehensive answers: does the economic *status quo* incentivize the creation of enhanced international financial regulations?

2. Big Picture

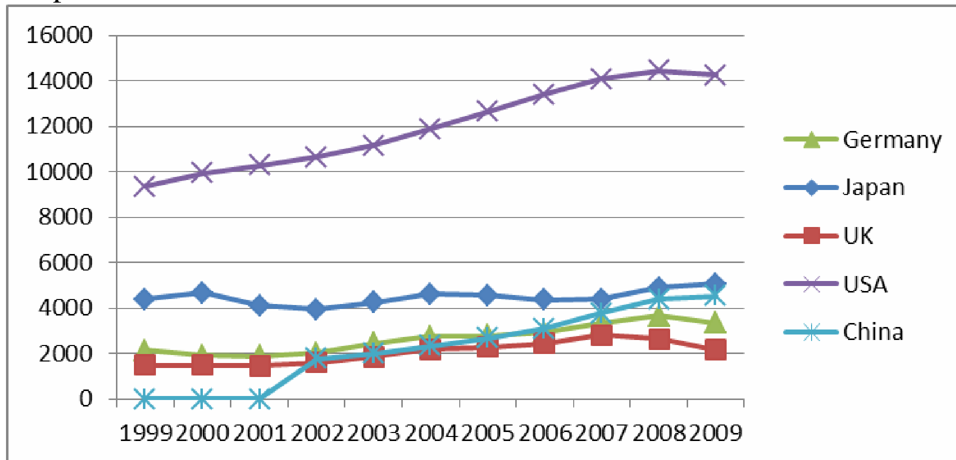
The goal of this section is to map the primary denominators that UK, USA, Germany, Japan, and China hold vis-à-vis the global financial regulations. Herein, not all the variables are attempted to identify. Instead, the focus is on variables that possibly impact the respective economies' ability and interest in shaping international financial regulations. Therefore, firstly, the extent of the countries' international economic influence will be assessed; and secondly, the structure of the domestic financial systems next to the countries' economies will generally be observed.

While simply using the countries' GDP measures (see Graph 2.1) for reference, the US' GDP has performed the strongest throughout the first decade of the 21st century. From 1999 to its peak in 2008, it gained about $5 trillion, whereas enlarging the already huge gap with the follow-ups: Japan, China, Germany, and UK, respectively. Therefore, if only GDP measures were considered, the American interest would most likely have the predominant stance.

From another perspective, while considering trade patterns as measures of economic power, the American dominance is not as clear-cut. While the US and UK had current account deficits throughout the past decade, the Chinese, German, and Japanese applicable figures were almost their mirror images (see Graph 2.2; Graph 2.3). This phenomenon is elaborated by M. Wolf and his "savings glut theory." Briefly, he draws the link between the American "consumer of last resort" mentality and the export-accumulated wealth of China, Germany and Japan.[19] Furthermore, as he argues that the net exporting economies, especially China, accumulate foreign reserves, this creates global imbalances, and is potentially a major source of financial instability (discussed further under the section explicitly considering China).

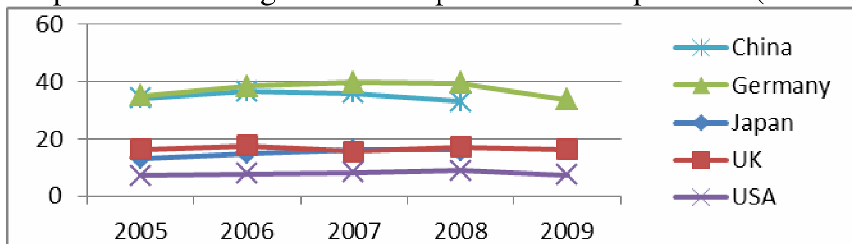
[18] Singer, D. A. (2007), p. 73.
[19] Wolf, M. (2008), p. 152.

Graph 2.1: GDPs in Billions of Dollars[20]



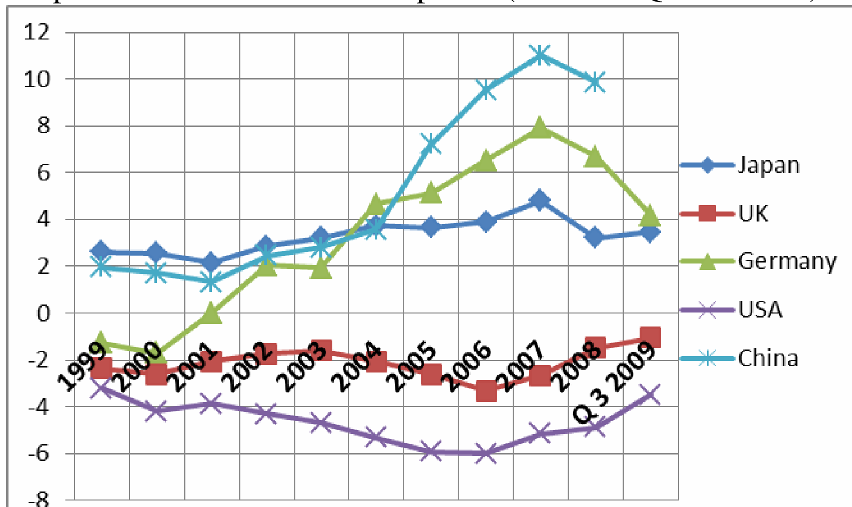
Source: IMF Principal Global Indicators.

Graph 2.2: Percentages of Net Exports of Goods per GDP (2005-2009)[21]



Source: IMF Principal Global Indicators.

Graph 2.3: Current Account Surpluses (1999- 3rd Quarter 2009)[22]



Source: IMF Principal Global Indicators.

[20] GDPs are nominal, seasonally adjusted (except China). For China, the trend of 3 Quarters' average was used for the 2009 aggregate GDP. 1 Yuan = .1464 USD was used.

[21] Exports are expressed in terms of free on board units (f. o. b.).

[22] Balance of Payment Statistics. '09 figure is from the 3rd Quarter . No data for China in '09.

M. Wolf's perspective is supported by B. J. Cohen, who argues that "the balance between states and markets [...] is being dramatically altered" as the result of financial globalization, which has caused severe unbalances between the nations that borrow and save.[23] From the prism of determining relevant macroeconomic impacts on enhancing international financial regulations, the frictions between saving- and borrowing nations may indeed pose multiple implications (for reference, see Table 2.1).

Table 2.1: Debt per GDP

Debt/GDP	2007	2009	2014
USA	63.1	88.8	112.0
Japan	187.7	217.4	239.2
UK	44.1	68.6	99.7
China	20.2	20.9	21.3

Source: UNCTAD[24]

From a rather different approach, while observing the nature of respective financial systems, several characteristics can be noted. With regard to UK, for example, her financial industry has been the primary source of British economic power for the past three to four decades. In 1993, as presented by Table 2.2, the UK's banking assets accounted for 259 percent of her GDP, whereas the ratios for Germany, Japan and USA were 152, 150, and 53 percent, respectively. More importantly, while observing the British Equity market capitalization (EMC) relative to her GDP, the ratio was at 140 percent. Note that the next highest EMC to GDP ratio was held by the US with 82 percent. Although these figures are from 1993, this highlights the vast impact that UK has had on the global financial system.

Table 2.2: Financial Markets Relative to GDP[25]

	GDP ($bn)	Banking assets, BA ($bn)	BA/GDP (%)	Equity market capitalization, EMC ($bn)	EMC/GDP (%)
US	6,301	3,319	53	5,136	82
UK	824	2,131	259	1,152	140
Japan	4,242	6,374	150	2,999	71
Germany	1,924	2,919	152	464	24

This table is adapted from Table 1 of Barth *et al.* (1997). The figures are those of 1993.

Herein, the latter provides rather significant connotations. Due to the market-based characteristics, both the UK's and the US' ownership structures provide higher rates of liquidity than other markets considered in this paper.[26] This is supported by the study conducted by Antoniou et al. (2008), which compares the capital structures of companies across the OECD countries, and

[23] Cohen, B. J. (2008), p. 14.
[24] Braga, C. A. P. (November 2009).
[25] The table was first presented by Kwock, C. Y., and Tadesse, S. (2006), p. 228.
[26] Mayer, C. (2008).

concludes that capital markets are a significant part for both the US' and UK's businesses, whereas this is notably not the case for markets that are traditionally more ownership oriented (e.g. Germany and Japan).[27]

In the cases of Germany and Japan, at the same time, the latter implies that the foundations of the two economies' financial systems are rather similar. This, for example, is supported by Bebenroth et al. (2008), who have analyzed the supervisory differences between the two countries due to the fact that both German and Japanese systems are heavily based on banking sectors.[28]

Therefore, from the perspective of shaping the framework for the following case studies, UK and US as the samples of market-based financial systems, will be observed within a single group. Next, since Germany and Japan both have bank-based financial systems, they will also be observed as a uniform case. And lastly, due to the quasi-communist nature of China, which rather lacks the traits of a neo-liberal economy, the emerging economic power will be considered as a separate case study.

All in all, due to the highly complex nature of all the five economic systems, the following sections will not claim to grasp a complete picture, nor will they claim to completely answer whether international cooperation could enhance financial regulations. Instead, the focus will be on incorporating the applicable macroeconomic denominators, and studying the literature-concerning aspects concerning financial regulations. Ultimately, this is expected to prove most effective in providing possible answers to the central research question: does the economic *status quo* incentivize enhanced international financial regulations?

3. United Kingdom and United States

	For International Regulatory Reform:	**Against International Regulatory Reform:**
UK	Stable financial industry key for economy; Market-based financial system; Global leader in regulatory convergence and deregulation.	Asymmetric global risk on financial industry.
USA	Stable financial industry key for economy; Market-based financial system; Global competition for the dominant economic power.	Asymmetric global risk on financial industry; Global competition for the dominant economic power.

[27] Antoniou, A., Guney, Y. and Paudyal, K. (March 2008), p.86.
[28] See section 4.1, where the study is mentioned as German regulatory reforms are discussed.

As the market-based financial model is distinctive to the Anglo Saxon economies, the British and American vibrant financial centers (London, New York) have arguably been leading the global market, whereas China, Germany and Japan have rather been the second-tier, although crucial, participants.[29]

The following section will consider the regulatory reforms that the American and British economies witnessed before the recent crisis. Next, the financial industry as the Anglo Saxon key economic sector distinguishing UK and USA internationally will be discussed on a broader perspective, which will then be followed by a discussion on the countries' post-crisis economic conditions.

3.1 Regulatory Reform

Despite most of the financial denominators, the process of regulatory reforms sets the Anglo Saxon economies rather apart. As noted by Llewellyn (2000), the UK's regulatory framework has been among the "most liberal systems around the world" ever since the Big Bang reforms were introduced in 1987,[30] whereas the American regulatory framework has not followed the trend of regulatory convergence. Under this section, first, an overview of the UK's regulatory reforms will be given, which will then be followed by the American regulatory trends.

Within the global financial system, UK became the first market to allow a single institution to conduct business "between the main areas of commercial banking, securities trading, and insurance." Consequentially, as Llewellyn argues, "the UK structure has been described as financial conglomeration rather than universal banking," which in turn has paved the way for global deregulatory pressures and convergence of financial institutions.[31]

Until the recent crisis, the process of liberalization seemed to benefit the British economy on a vast scale. While being eager to lead the way in converging supervisory institutions to a single regulatory agency, the newly elected Labor government of 1997 announced "a total reorganization of the institutional structure of financial regulation".[32] The result of this initiative was the formation of Financial Stability Agency (FSA). Almost instantly, FSA became the most powerful regulator in the world (since the potentially bigger regulatory framework within USA had not followed the trend of regulatory convergence, nor, as discussed later, has it done so today).

Therefore, just as was the case with the follower countries- Germany and Japan- this was initially seen to benefit the British financial sector via exploitation of economies of scale, transparent regulation, and avoidance of

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[29] See, for example: Kwock, C. Y., and S. Tadesse (2006).
[30] Llewellyn, D. T. (2000).
[31] Llewellyn, D. T. (2000), p. 309-310.
[32] Llewellyn, D. T. (2000), p. 311.

contradictory measures by overlapping regulatory agencies.[33] However, after the recent crisis sparked, the process of convergence and deregulation seemed to have stretched too far.[34] Subsequently, the crisis came as a surprise, and the regulators did not manage to provide comprehensive responses to the crisis before early 2009 (when the UK's Banking Act was announced in February 2009).[35]

According M. Hall (2009), the Special Resolutions Regime, which was enacted under the Banking Act of 2009, was the first step in the row of many that financial regulators needed to take to once again meet the "top priority" of public policy. The SRR only contemplated the framework for dealing with problematic financial institutions, it did not provide the tools that regulators need for actual prudential measures. For example, Hall discusses the need to properly "calibrate" micro- as well as macro-prudential policy so that "systemic risk" and "inherent pro-cyclicality in the financial system" could be reduced.[36] This means more supervision, but also smarter and efficiently drafted regulations- a conclusion that several authorities have made (e.g. Bank of England and the Warwick Commission as discussed earlier).[37]

Just as with regard to UK, the American regulators reported their first comprehensive responses to the crises no earlier than 2009. Herein, the US Department of Treasury's White Paper on financial regulatory reform would perhaps be one of the most significant milestones. In its outline, the Department of Treasury conceives the government's previous regulatory shortfalls: "while the crisis had many causes, it is clear now that the government could have done more to prevent many of the problems from growing out of control and threatening the stability of our financial stability."[38]

With regard to the previous regulatory short-falls, they note similar aspects that several scholars have concluded (for example, the information asymmetries for non-depository institutions that essentially conduct the same business than banks, but are not subject to as restrictive rules). Subsequently, the White Paper proposes six key steps for overcoming the asymmetries: "A new Financial Services Oversight Council of financial regulators to identify emerging systemic risks and improve interagency cooperation; New authority for the Federal Reserve to supervise all firms that could pose a threat to financial stability, even those that do not own banks; Stronger capital and other prudential standards for all financial firms, and even higher standards for large, interconnected firms; A new National Bank Supervisor to supervise all federally chartered banks; Elimination of the federal thrift charter and other loopholes that allowed some depository institutions to avoid bank holding

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[33] Llewellyn, D. T. (2000), p. 312.
[34] See, for example, Gieve, Sir J. (2008).
[35] Hall, M. J. B. (2009).
[36] Hall, M. J. B. (2009), p. 53.
[37] For more detail, see Section 1.2 on pages 4 and 5.
[38] Department of the Treasury, (2009), p. 2.

company regulation by the Federal Reserve; The registration of advisers of hedge funds and other private pools of capital with the SEC."[39]

For the most part, as the American market-based system is favoring minimal state intervention, the fear for "big government" under such proposals is relatively quick to emerge. And while taking a look at the lobby of financial corporations, the industry is already working against the potential overhaul of financial markets.[40] However, given the extent of market failure under too little regulation, the government is ambitious to move forward.

Herein, on a broader level, the White paper also outlines five key objectives that should guide the future drafts of financial regulations. Briefly, the objectives concentrate around "robust supervision and regulation of financial markets", prevention of financial abuse, equipping the government with effective financial crisis management mechanisms, and raising "international regulatory standards" by improving international cooperation.[41]

All in all, the Obama Administration's controversial preference for greater government intervention is quite clear. Nevertheless, since the American financial system is the biggest in the world, the international cooperation will certainly not work effectively unless the US is determined to contribute. Thus, after reviewing the regulatory reforms that the Obama Administration is proposing, it can likely be concluded that the international markets are probably more inclined towards genuine cooperation than it was the case before the crisis.

Conclusively, despite the recent setbacks, UK and USA have historically been the hallmarks for a well-functioning financial system- and are likely to remain this way for a rather long period. This will most likely be also true with regard to creating the trends for global regulatory reforms. Herein, in order to understand the probable national interests, the key priorities with regard to the global financial system need to be addressed. While attempting to do so, the next section will consider the two economies' financial industries more closely, whereas the remaining section will observe their post-crises conditions.

3.2 Financial Industry

Due to the interconnectedness of the financial markets and the real economy, the Anglo Saxon strategic interest in stable global financial markets is quite explicit. In case of the UK, for example, the share of financial services to her GDP rose to 9.4 in 2006.[42] In the US, at the same time, the highest Rates of Return on Sector-Specific Capital are reported within sectors such as "Securities, commodity contracts, and investments" (92%), "Insurance carriers

[39] Department of the Treasury, (2009), p.3.
[40] See, for example: Eggen, D. (2010).
[41] Department of the Treasury, (2009), p. 3 – 4.
[42] Swain, S. (2008).

and related activities" (36%), and "Funds, trusts, and other financial vehicles" (12%)- in short, within areas closely intertwined with the financial industry.[43]

Handa and Kahn (2008), while studying the financial market's importance, characterize the effect of intertwined characteristics of financial development and economic growth as a "symbiotic relationship", which, if properly managed, could significantly benefit both financial and non-financial sectors.[44] Via econometric analysis, they conclude that the co-integration between financial and non-financial sectors is expected to provide a strong correlation "between the financial sector and GDP".

In fact, they note that as the result of the model, "a more immediate impact" between the GDP and financial sector is expected to be shown for the US' and UK's co-integration variables than for any of the other economies in the study (which among several other countries, also includes Germany and Japan).[45] With regard to the Anglo Saxon financial industry, this is another affirmation that while drafting financial regulations, the wellbeing of the British and American financial sectors will be the economies' primary concern since it correlates closely with the economic interests of all the other sectors.

Herein, the co-integration of the financial sector and the real economy has been subject to several studies. Explicitly in relation to UK's and US' financial industries, both volatility as well as greater relative shares of the respective financial industries within the countries' macro economies, have most likely contributed towards the facilitation of co-integration.

For example, according to C. Mayer (2008), most of the British market volatility comes from the significant role of the UK's stock market, and the developed ownership structures that only the US can match. With regard to UK, only 16 percent of the largest 170 listed companies have a single shareholder owning more than 25 percent of the company, whereas only 6 percent of the largest companies have a single majority shareholder. If comparing the figures to Germany, the contrast is remarkable: nearly 80 percent of top 170 German companies have a single shareholder owning at least 25 percent of the company.[46]

The link between the unique liquidity of the British and American stock exchanges, ownership structures, and financial industries' importance is another aspect that highlights the strategic importance of this particular industry for UK and US. Since single shareholders are more likely to hold long positions, whereas dispersed ownership rather increases the participation of mutual funds, insurance companies, investment banks and other financial institutions, the Anglo Saxon financial industry is by design globally attracting more financial market participants than Germany, Japan or China. Hence, in times of volatility, their financial industry will also affect the real economy more than the economies not holding as volatile market characteristics.

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[43] Fisher, E. O'N., and Marshall, K. G. (May 2008), p. 48
[44] Handa, J., and Khan, S. R. (2008).
[45] Handa, J. , and Khan, S. R. (2008), p.1043.
[46] Mayer, C. (2008), p. 619.

Conclusively, since the financial markets are rather global in nature, it might not be as reasonable to go too much into detail while comparing different domestic market characteristics. However, since the vibrant financial industry is an integral part of the Anglo Saxon economies, the US' and UK's economic strategies will certainly consider the wellbeing of their financial markets among first priorities. Therefore, with regard to international financial regulations, it is certainly in their interest to have stabile and commonly agreed upon regulatory arrangements. Nevertheless, this might not mean that in reality, the explicit regulatory framework, which is suitable for the American or British financial industry, would be reasonable for the Chinese quasi-communist, or the Japan and German bank-based financial markets, or *vice versa*.

3.3 Post-Crisis

Similarly to most of the developed economies, the recent crisis has drastically weakened both the British and American economic prospects. Among several issues, the British fiscal position has worsened in a quick pace. While looking at Table 1.1, it can be noted that UK's public debt increased from 44.1 percent in 2007 to 68.6 percent of GDP in 2009. The equivalent readings for the US are from 63.1 percent to 88.8 percent, respectively. Furthermore, the debt ratio is projected to reach more than 100 percent for UK and more than 112 percent for US by 2014.

For UK, this would mean more than doubling the British national debt within only 7 years, whereas for the US, the country's economy would hold by far the highest debt in the World, if the face value is considered. Cecchetti et al (2010), while estimating the impact of drastically increased debt levels throughout the industrial world, conclude that the Anglo Saxon current path, as is the case for Germany, Japan, is unsustainable.[47] Therefore, since the public sector's debt is likely to impact the efficiency of British and American economic recovery (instead of raising taxes and lowering investments, now should ideally be the time for the government to compensate for private sector's lack of consumption), the countries' prospects are not as bright.

With regard to enhancing financial regulations, as the Obama Administration, and the British financial authorities, have presented, the governments seem to be determined to reduce the influence that the financial institutions have both on the American and British economies. This is also true internationally, as the G20 nations have been meeting regularly to coordinate government action for tackling the aftermath of the Great Recession. Herein, apart from the looming budget deficits, the US' dispute with one of their main trading partners- China- would perhaps be a relevant area worthy to follow in the post-crisis world.

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[47] Cecchetti, S. G., Mohanty, M. S., and Zampolly, F. (February 2010).

As the Chinese fixed exchange rate (discussed under the section concerning China) is seen to hurt the American economic interest, this could potentially create the next international dispute.[48] From the US side accusing China of exchange rate protectionism, and China disliking the US' pressure, the risk for an international conflict, and a potential trade war, is certainly there. Although it must be noted that within the past few months, some of the heated rhetoric has been downgraded, there are still several areas of concern, including global financial stability, for why the post-crisis US – China relations have received notable international attention.

Additionally, while analyzing the potential economic determinants that could contribute towards enhancing the global financial system, the Chinese potential competition for the World's dominant economic power could be one of the areas, where competition between the US and China may unbalance the rather fragile atmosphere. As depicted on Table 4.1 under the section discussing Japan, China has already surpassed Japan and is approaching the American GDP figures rather fast (being currently at nearly 40 percent of the US GDP).

Moreover, since the US economic growth will likely be rather weak due to both the private and public sector's debt burdens, the gap between China and USA is likely to decrease further. Therefore, overall, the post-crisis American economic dominance is probable to gradually decrease, whereas several emerging economies, especially in Asia, will gain some of the advantages that America has held so far. This, however, does not mean that the American economy would become irrelevant. On the contrary, as discussed above, the US is still by far the main "player" on the global market.

All in all, from the Anglo Saxon perspective, the post crisis priority is to reverse the economy back to growth. In short term, this primarily requires prudent fiscal measures, which at the same time, demands effectively quitting the government's liquidation programs. In the longer term, since the financial industry holds the key position for UK and US, it is in the countries' firsthand economic interest to enhance the financial regulatory system- both domestically and internationally. Therefore, while asking whether the post-crisis Anglo Saxon system has considerable incentives for enhancing international financial regulations, it is probably more likely to do so than any of the subsequently analyzed economies- China, Germany, Japan.

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[48] See, for example: Pettis, M. (2010).

4. Germany and Japan

	For International Regulatory Reform:	Against International Regulatory Reform:
Germany	Eurozone; Bank-based financial system; Pro regulatory convergence and deregulation.	
Japan	Competition with China and South-East Asia; Pro regulatory convergence and deregulation.	Competition with UK and USA over the global financial centers;.

Since both the German and Japanese financial systems are largely bank-based, they are often compared to each-other. As discussed under the Big Picture section, there are several key reasons for why Germany and Japan hold common strategic positions within the World economy next to the market-based Anglo Saxon, and quasi-communist Chinese models.

The following sections will therefore study the German and Japanese regulatory reforms, which have both moved towards institutional convergence, in a comparative setting. Thereafter, a look will be taken on the economies' internationally distinguishing variables and subsequent post-crisis conditions.

4.1 Regulatory Reforms

For both Japan and Germany, as for UK, one of the major issues regarding regulatory reforms has been the integration of supervision on insurance, banking, and securities industries. As these industries have become increasingly intertwined and therefore nearly impossible to separate between each-other, the British leadership in converging the regulatory bodies has been followed. In this section, first, a look at the core of German regulatory reforms will be taken, followed by a look at the Japan's applicable reforms. In the succeeding section, the internationally distinguishing variables will be studied- Eurozone for Germany, and the Asian regional competition for Japan. Lastly, a look at the two economies post-crisis conditions will be taken.

With regard to Germany's regulatory reforms, particularly, M. Schüler from ZEW Mannheim[49] discusses how Germans have followed the global "trend of integrated financial supervision" ever since the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin)[50] was established in May 2002.[51]

[49] The Center for European Economic Research.
[50] Federal Financial Supervisory Authority.
[51] Schüler, M. (*2008).*

Additionally, Pellerin et al (2009) write how Japan and UK have undergone a similar "consolidation" process, whereas the US might soon follow the path.[52]

With regard to Germany, particularly, the creation of BaFin represented significant changes- although the implications are multifaceted. Instead of having three parallel authorities, a single financial regulator, solely responsive to the German Minister of Finance, was founded. Since the regulations gained efficiency via reduced bureaucracy, and the framework became considerably better to comprehend, the immediate impacts were mostly seen positive.[53]

M. Schüler (2004), for example, enlists some of the positive implications briefly after BaFin was established: "Unification allows the realization of cost savings through economies of scale; the superiority structure should reflect the integration of financial sectors; regulatory arbitrage can be avoided; accountability is enhanced; and international co-operation is fostered." Ultimately, the new regulatory framework became able to cope with "the blurring of borders between banks, insurers and financial service providers"[54]. Nevertheless, Schüler also leaves room for skepticism by outlining some of the downsides: "Unification could lead to lack of clarity; an integrated agency could suffer from diseconomies of scale; concentration of power could vitiate democratic policies; and moral hazard concerns could be extended across the whole financial sector."[55]

From the prism of a more recent study- Bebenroth et al (2008), which compares the Japanese and German banking regulations- the German regulatory model stands considerably efficient.[56] Among other aspects, they refer to the IMF stress tests, which analyzed the German banking sector in 2003. Based on Bebenroth et al, "the stress tests were done for a significant increase in a borrower's probability of default (of 30% and 60%, respectively), for a 30% decline in stock market prices within a period of one month, for a significant shift in the yield curve, and for a 15% exchange rate change of the Euro against the US-Dollar within one month. Moreover, macro stress tests were conducted which assumed that several risk factors were positively correlated."[57] Eventually, the conclusion was that the tests "did not indicate a risk to the stability of the German banking system."[58]

In the case of Japan, while the economy was suffering under enduring stagnation, the "Big Bang" financial reforms were initiated in late 1996.[59] During the "Big Bang" reforms, which according to Dekle (1998) copied the

[52] Pellerin, S. R., Walter, J. R., and Wescott, P. E. (2009).
[53] Former agencies that are now "united": BaKred the banking regulator, BaWe the securities regulator, and Bundesaufsichtsamt für das Versicherungswesen (BaV) the insurance regulator". For details, see: Westrup, J. (2007).
[54] Schüler, M. (2004), p 2-4.
[55] Schüler, M. (2004), p. 3.
[56] Bebenroth, R, Dietrich D., and Vollmer U. (2009).
[57] Bebenroth et al. (2008), p. 199.
[58] Bebenroth et al. (2008), p. 199. Also, see Deutsche Bundesbank (December 2003), p. 53-61.
[59] Dekle, R. (Summer 1998).

London's radical reforms from late 1980s, the Japanese financial system aimed to compete with the global financial centers of New York and London. Among several other policy-steps, a "financial supervisory regime more consistent with deregulation" was introduced.

According to Dekle, the "Big Bang" did indeed seem promising in shaking up laggard markets, and inducing the financial sector towards stronger performance. However, the reforms were not going far enough as several issues were yet to be solved (e.g. government's flawed intermediation between borrowers and lenders; problems with "devising tax measures that are consistent with financial deregulation; and establishing a clear, rules-based exit strategy for failing financial firms").

Today, despite the initially high hopes, it is widely known that most of the "Big Bang" failed. Okomato, I. (2005) elaborates on some of the reasons by referring to the system's "inability to go beyond liberalizing the securities industry by challenging the government's protection of the banking sector, and to the government's haphazard intervention in the stock market."[60] To some extent, the turbulent macroeconomic factors could be blamed. On the other hand, as Hoshi and Kashyap note, the "financial sector problems seem too big to be explained by *purely* cyclical factors".[61]

Therefore, Hoshi and Kashyap refer to the "conscious policy of Japanese banks to keep extending credit to firms even when the prospects for being repaid are limited". Moreover, they argue that the banks' willingness to issue such loans was caused by the regulatory environment, which in reality, simply prevented failing companies from exiting the market. Subsequently, over the two decades, the scholars argue that the Japanese economy lost up to 20 percent of its GDP.[62]

From the perspective of evaluating the effect of regulatory reforms, such a conclusion is certainly devastating. And from the regulator's lens, they seem to have taken the blame. E.g. Ito Takashi (Ministry of Finance) discusses that "regulators felt justified in providing less-than-candid estimates [while concerning] the magnitude of the non-performing loan problem". He goes further: "when the problem became more serious (say by 1994), the reluctance became more a fear that a systemic crisis might result from full disclosure."[63]

Along the same lines, M. Imai (2009) discusses that the bank failures in Japan during 1999-2002 (right after the Asian crisis) were exacerbated by the regulators' "tendency to delay declarations of insolvency in prefectures that supported senior politicians of the ruling Liberal Democratic Party (LDP)."[64] Ultimately, he concludes that "politicization of bank insolvency

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[60] Okamoto, I. (Spring 2005).
[61] Hoshy, and Kashyap (2004), p. 6.
[62] Hoshy, and Kashyap (2004).
[63] Hoshi, T., and Patrick, T. (2000), p.88.
[64] Imai, M. (February 2009).

resolution might be one of the fundamental problems that one must take into account when designing bank regulation and supervision".[65]

When asking, whether the lessons of "Great Stagnation" were learned, the literature hints on various conclusions. E.g. Pellerin, et al. (2009) emphasize the convergence process of various regulatory institutions, which as with Germany, was also an important trend in Japan.[66] Specifically, they argue that as the Japanese Financial Services Authority was emerged into a consolidated regulator between 1998 and 2000, the "transition […] was more dramatic than in many other countries because the Ministry of Finance (MOF) held significant regulatory power prior to reform."[67]

Conclusively, the 2000s' tendency to gather insurance, banking, and securities regulators under a "single roof" has been dominant in most of the developed economies (including Japan, Germany, and UK). Nevertheless, this does not mean that such reforms have abolished international discrepancies within the structure and role of regulatory agencies. Especially due to China, which, as discussed later, may potentially undermine the efficiency of global financial regulations.

4.2 Eurozone and Germany

Before discussing the implications of the crisis on Germany, in order to adequately grasp the determinants of the German financial system, its leading role in the Euro area remains to be analyzed.

Cohen and Subacchi elaborate on the fact that despite euro's broad scope in terms of covering European markets, it is "largely a passive participant in global payments developments and remains a weak force in monetary diplomacy." For Germany- the biggest economy within the Eurozone- such short-falls are no doubt costly. One of the major sources of excess cost is the controversy between fiscal policies, which differ across the euro-area's member states; and monetary policy, which is conducted by the European Central Bank- a single authority across EMU. Due to the unnatural segregation of these economic policy mechanisms, Cohen and Subacchi call the phenomena "A one-and-a-half-currency-system". Subsequently, for the German financial system, the "semi-currency" characteristics propagate external risks, and pose excess costs (as currently illustrated by the Greek budget crisis).

S. Dullien, and U. Fritsche add another perspective, while noting in the Journal of Post Keynesian Economics that "the increasing macroeconomic imbalances within the European Monetary Union (EMU)" have "coincided" with the fiscal discrepancies of the South-European deficit-running nations and the German budget surpluses. While focusing their analysis on measuring

[65] Imai, M. (2009), p. 151.
[66] Pellerin, S. R., et al. (2009), p. 121.
[67] Pellerin, S. R., et al. (2009), p. 149.

divergence in unit labor cost throughout EMU, and the USA, they conclude that the budget deficit nations (such as Spain, Portugal, Greece) exhibit increased unit labor costs above their long term average. This in turn poses potential risks for the entire financial system, which obviously interconnects Germany and other member states throughout the EMU[68].

Furthermore, after the Greek default on its debt became more likely, the German system- as the main source of stability for Eurozone- has had no other option but to contribute towards the Greek bailout. Subsequently, as Joschka Fischer (2010) points out, Germany "is withdrawing into its shell", which implies that costs of divergence within Eurozone are beginning to reduce the German willingness to invest into euro's stability outside its own borders[69].

Ultimately, in the context of this paper, the Eurozone's intertwined nature makes Germany unique. China, Japan, UK, and USA all have explicit control over their fiscal and monetary policies. Since Germany lacks similar measures over these two variables, the nature of Eurozone may pose a potential source of conflicting interests- especially while considering key interests in enhancing global financial regulations.

4.3 Asian Competition and Japan

By 2000s, after the "slow moving financial crisis" peaked with the 1997-1998 financial crises, the Japanese macro economy was vastly unstable.[70] As presented by M. Fukao (2007), the duration of the financial crisis introduced a longstanding period of deflation and forfeited output. Although Fukao calls the era a "lost decade" for the Japanese economy, and hence for its role within the Asian region, he marks some signs for a potential "comeback" between 2003 and 2006- mainly due to "strong recovery of stock prices".[71]

However, while the boom-time improvements helped the Japanese economy to shift towards growth, the competing nations still grew faster. This is especially true with regard to the Japan's regional competitors- e.g. China. As seen from Graph 2.2 and Graph 2.3, the main engine for higher growth- net exports- was growing at a much faster rate in China than in Japan. Moreover, although Japan remained the second biggest economy during the boom-times, it is estimated to surrender the position to China in 2010 (Table 4.1).

In retrospect, several structural shortfalls, including financial, can be blamed for the Japan's inability to pick up sustainable growth for nearly two decades. For example, Lee and Kwak (2009) compare the fast-growing Korean economy to the Japanese, and ask whether the growth discrepancies rely on Korean neo-liberal reforms, whereas the Japanese system has remained unchanged. Although they conclude that further empirical evidence is needed

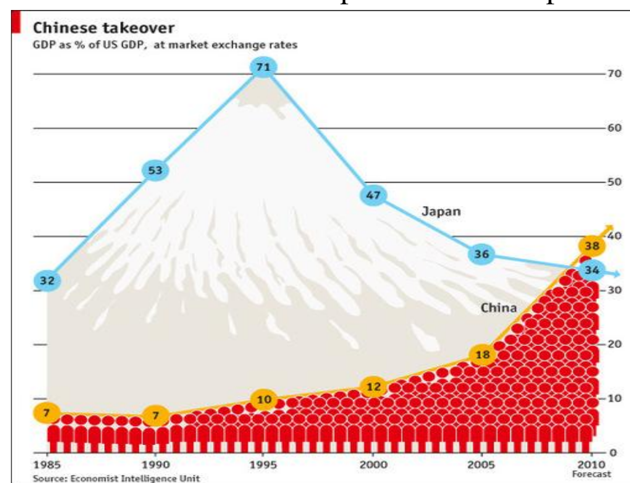
[68] See Dullien, and Fritsche (2009), p. 454-456.
[69] Fischer, J. (2010).
[70] Fukao, M. (2007).
[71] Fukao, M. (2007), p. 274.

to pinpoint explicit reasons, they agree with the "academic consensus" that the Japanese system is not flexible enough to face the growing Asian competition.

T. Albrecht (2005), for instance, estimates the next probable "economic center of Asia" in 20 years, and concludes based on "GNP-weighted centrality indices" that Japan's decline will be "more than offset" by China's "significant increase".[72] Subsequently, he argues, that "the total economic weight of Northeast Asia is likely to *decrease* slightly compared with Southeast Asia and Greater India over the next 20 years. On the worldwide stage, Northeast Asia as a whole will grow in importance, although less quickly than Greater India and Southeast Asia."[73]

All in all, as Japan has been subject to thorough research over the recent decade, most of the literature concerning Japan's performance in the 2000s has considered the impact of the '90s Asian crisis. After the recent financial crisis struck, however, the outlook for Japan has changed. Hence, the following section will briefly consider the new post-crisis conditions for both of the bank-based financial systems- Germany and Japan.

Table 4.1 China's GDP versus Japan's GDP as a percent of US GDP



Source: The Economist Intelligence Unit

4.4 Post-Crisis Germany

After the crisis struck, and the markets went downfall in October 2008, the preventative stress tests, as conducted on the German financial system by IMF in 2003, became real world scenarios. Moreover, in several cases, the stress tests turned out overly optimistic. As discussed by Dieter Heribert (2009), the German response to the crisis was often "hastily implemented and lacked a coherent strategy".[74] This was foremost caused by the German banks'

[72] Albrecht, T. (August 2005), p. 359.
[73] Albrecht, T. (2005), p. 377.
[74] Dieter, H. (2009–2010).

exposure to the US subprime mortgage markets via their investments into the US subprime businesses.

In more detail, I. Hardie and D. Howarth (2009) from University of Edinburgh have studied the crisis' impact on the German financial sector, while asking "why did the supposedly more protectionist and conservative German banking system […] suffer much higher losses?"[75] They refer to IMF's July 2009 statistics, according to which "9 percent of total global write-downs" accounted for German depository institutions. Furthermore, they note that the majority of the losses were taken by large German government-owned banks- known as the German Landesbanken (LB).[76]

Matin F. Hellwig (2009) characterizes the pre-crisis situation as German state-owned banks "sponsoring American entities, so called 'conduits' and 'structural investment vehicles' that invested large amounts of money in subprime-mortgage-backed securities"[77]. Hellwig sees the cause of such reckless "sponsoring" in the preceding decade of low interest rates (real and nominal), and "of low interest margins for financial intermediaries", which ultimately caused what he calls a "yield panic"[78]- the investors' necessity to cover operating costs from what they earned.

Once the European Commision "banned the state guarantees" for refinancing, as Hellwig points out, the German state-owned banks' appetite for MBS' high yield became even bigger. Hence, the stage was set rather fragile for the upcoming collapse. When the crisis indeed hit after the MBS suppliers started to go bust, the German financial sector was already too attached. Hellwig brings the example of two multibillion depository institutions- Industriekreditbank (IKB) and Sächsichse Landsebank- which both would not have survived unless the local authorities would not have bailed them out[79].

While seeking the reasoning for such underperformance in the German state-owned banks throughout the crisis, several conclusions can be made. H. Harald, and T. Marcel (2009), for instance, see one of the main reasons in the biographies of the manager. As they studied 592 supervisory board members in the 29 largest German banks, a "pronounced difference" was found "in the finance and management experience of board representatives across private and state-owned banks"[80]. Based on their data, they concluded that "supervisory board incompetence is related to losses in the financial crisis. Improved bank governance is therefore a suitable policy objective to reduce bank fragility."[81]

For future regulatory directions, T. Kick et al., for instance, study explicit regulatory intervention data among German banks during 1994-2008,

[75] Hardie I., and Howarth, D. (2009), p. 1017.
[76] Hardie I., and Howarth, D. (2009), p. 1018.
[77] Hellwig, M. F. (2009), p. 164.
[78] Hellwig M. F. (2009), p. 164.
[79] Hellwig M. F. (2009), p. 171.
[80] Hau, H., and Thum, M. (October 2009).
[81] Hau, H., and Thum, M. (2009), p. 1.

and conclude that "concerted micro- and macro-prudential policies are key to facilitate distressed bank recovery."[82] Therefore, their study hints that the German post-crisis recovery does not only depend on raising the individual skill level of relevant actors, but also the efficiency of over all regulatory policy.

Conclusively, the principal concept of embracing liberal markets, with as little state intervention as possible, has certainly still a much clearer role within the German economy. Nevertheless, systematic as well as institutional changes are no doubt under way. This is likely to be relevant in both German domestic, as well international economic spheres. If, at all, a domestic vs. international delineation can be correct anymore- especially with regard to globalized financial markets.

4.5 Post-Crisis Japan

As the subprime mortgage crisis evolved into full scale financial crisis, the Japanese experience with the Asian crisis became an important reference point. For example, when E. S. Rosengren, the CEO of the Federal Reserve Bank of Boston, gave a speech in front of the Institute of International Bankers in March 2009, he repeatedly compared the Japanese experience to the current crisis.[83]

From the Japan's post-crisis perspective, such a "phenomenon" provides its markets additional attention. Not only can the Japanese financial system offer experience with regard to appropriate policy measures, but it could also be hypothesized that due to their past experience, the Japanese economy was more prepared for the global Great Recession. However, beyond a mere hypothesis, most of the literature seems to deduce otherwise. Thus, while comparing the five economies within this paper, Japan seems to still stand in a relatively poor position.

Garret, G. (2010) states in his study regarding the world after the financial crisis, that "the financial crisis exposed Japan's economic recovery from the lost decade of the 1990s as being more apparent than real, built on booming exports to the US and China rather than the reforms so desperately needed at home."[84] He goes further by stating that "the suffocating legacies of massive public debt, sclerotic regulation and an aging and shrinking population will likely consign Japan's next decade to a painful process of managing long-term economic decline."[85] Herein, Garret's reference to the public debt problems is rather on point, as the Japanese net debt is estimated to reach 240 percent of its GDP by 2014 (see Table 1.5).

Nevertheless, not all the scholars agree that the debt issue will harm Japan, as the yields of the Japanese bonds remain healthy, and the stimulus

[82] Kick, T., Koetter, M., and Phogosyan, T. (January 2010).
[83] Rosengren, E. S. (2009).
[84] Garret, G. (January 2010), p. 31.
[85] Garret, G. (2010), p. 31.

packages have managed to avoid a financial meltdown.[86] Yet, this is not to say that the post-crisis conditions would not have harmed Japan's long-term prospects. E.g. Tokuaka, K. (2010) concludes that one of Japan's major problems is the massive population aging, which risks its long tradition of financing public debt "in a smooth manner". Therefore, after the economic conditions have stabilized, a "sound public debt management and fiscal consolidation will be critical" to reduce the risk of a public debt default, and thus, a potential breakdown of Japan's macro economy.[87]

Conclusively, while considering that Japan faces a large amount of public debt next to its post-crisis' struggling export sector, its stability seems rather fragile. As Japan's economy entered the recession after barely recovering from the "lost decade", its stabilization-period was rather short. Subsequently, although the boom created some "breathing space" as financial regulations became more lax and the government's inadequate policy interventions less frequent, the current post-crisis picture is still rather troublesome. This is mostly so due to the fact that the necessary structural economic changes have not taken place yet.

5. China

	For International Regulatory Reform:	**Against International Regulatory Reform:**
China	International trade.	Exchange rate protectionism; Foreign Reserves; Foreign loans; Quasi-communist financial system; Economic rivalry with Japan and USA.

"From being a rounding error a decade ago, the financial clout of China now trails only that of America."[88]

5.1 Regulatory Reforms

Over the past three decades, China's financial markets have become increasingly liberalized.[89] After the moderate banking reforms were introduced in 1980s, the 1990s introduced a fast transformation from the former Special Banks (SBs) into state-owned commercial banks (known as the Big Four). After China was accepted to WTO in 2001, the reforms were carried further: as the membership of WTO required opening the market to foreign

[86] See, for example Tokuoka, K. (January 2010).
[87] Tokuaka, K. (January 2010), p. 19.
[88]Red Mist. *The Economist. February 4, 2010.* http://www.economist.com/business-finance/displaystory.cfm?story_id=15453014
[89] Kwong, C. C. L. (2009).

corporations, China became impelled to raise the competitive standards for the Big Four- the gigantic state owned commercial banks.[90] Without attempting to map all the outcomes of the financial reforms, some major implications will herein follow.

First, once China recognized that global trade poses great potential, explicit policy initiatives redefined its financial priorities. In 1990s, one of the major benchmarks was "paving the way to WTO accession", which among several other aspects, provided incentives to reform the mono-bank system.[91] For the Chinese financial architecture, this meant a remarkable revolution. According to Charles L. Kwong, "the aim was to achieve at least three major goals: (1) to develop the People's Bank of China (PBOC) into an independent and fully fledged modern central bank to regulate the national financial market and maintain macroeconomic stability, (2) to commercialize the four SBs by separating commercial lending from policy lending, and (3) to nourish a more diverse and competitive banking sector by allowing more commercial banks to enter the market."[92]

Globally, perhaps the biggest impact of the redefined markets was posed by international competition.[93] After its accession to WTO in 2001, China was given 5 years to completely open up the markets to foreign financial corporations. To the state owned commercial banks, this meant strong incentives for increasing efficiency. For other market-participants, the foreign competition diversified options due to the emergence of a competitive credit market.

Second, after the financial reforms became rapid in the first half of 2000s, the real economy began to post stronger results. For example, the amount of non-performing loans (NPLs) issued by the Big Four, which peaked 25% at the end of 1990s, was brought down to 21.4% by the end of 2003.[94] Despite remaining exceptionally high for "western" standards, this was a victory for the Chinese policy makers.

Third, the once fundamentally communist mono-bank system was largely replaced by a capitalist financial market. Before the crisis struck, the government control gradually drifted, especially since considerable fractions of the Big Four were separated from direct government control, and international banks started to conduct business in renminbis. Moreover, in 2007, right before the financial turmoil, the Chinese government supported the Bank of China and the China Construction Bank with $45 billion from its foreign exchange reserves to become joint-stock companies, which would "soon be placed in the stock exchange". [95] According to Yao, Chunxia, and

[90] Kwong, C. C. L. (2009), p. 9.
[91] Lo, W-C, and Ng, M. C. M. (2009).
[92] Kwong, C. C. L. (2009), p. 10.
[93] Yao, S., Jiang, C. and Feng, G. (2007).
[94] Lo, W-C, and Ng, M. C. M. (2009), p. 21.
[95] Yao, S., Jiang, C., and Feng, G. (2007), p. 2.

Feng, this was "by far the boldest and toughest decision of the government to convert the big state banks into truly commercial institutions".

Nevertheless, once China's economy experienced setbacks due to the recent crisis, the Chinese government used its control over the banking industry and "strongly advised" the SOCBs to extend loans for small and medium size companies[96]. From the perspective of avoiding massive bankruptcies, the steps were certainly justified. Ibid, it also presented the government influence over the seemingly independent banking sector. For the developed economies, no such "advices" could have ever worked. Did the Chinese system have an advantage?

While considering the inefficiencies within the system, the quasi-communist system's advantages, even if present in current crisis, are certainly implicit, and mostly illusory. However, from the perspective of effectively manipulating with the market and "forcing" stability through artificial policy measures, the governments' work has arguably been successful. Nevertheless, several controversies, that ultimately are likely to undermine the long-term stability, can be identified. The following section will consider two of the perhaps most controversial measures that are likely to challenge the Chinese official policy beyond simply reforming the financial regulations.

5.2 Exchange Rate Control and Current Account Surplus

As stated above, although the Chinese economy has become substantially less government-influenced, the financial issues, including the Chinese monetary policy, are reluctant to change. James A. Dorn (2008), a scholar from Towson University and an editor of the Cato Institute, argues for instance, that China still lacks explicit mechanisms for affecting monetary variables (i.e. the exchange rate, interest rates), whereas the central government determines most of the "macroeconomic prices". Thus, while regarding the macro market, it is important to recognize that the quasi-communist system influences virtually all of China's economic determinants, including their monetary policy.

First, to understand the crux of China's monetary issues beyond just noting its socialist characteristics, the exchange rate policy needs to be examined. According to J. A. Dorn, "China will be able to have an independent monetary policy aimed at long-run price stability, which fosters financial stability, only if it floats the yuan and eventually allows full convertibility."[97] This is supported by M. Wolf, who argues that the begged renminbi is unsustainable next to the surplus-created "savings glut" for both the Chinese and its trading partners[98]. Yet, China disagrees. Just recently, while responding to Obama-administration's accusations of "exchange rate protectionism", the Chinese officials delivered a clear response by accusing

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[96] Kwong, C. C. L. (2009), p. 11.
[97] Dorn, J. A. (2008), p.547.
[98] Wolf, M. (2008).

the US administration in "trade protectionism."[99] What is their rationale for disagreeing with both the scholarly and political elite of most of the developed economies?

Although the answer is multifaceted, several key reasons prevail. Perhaps two of the most important reasons are China's need to keep the cost of exports down (in 2008, 33% of China's GDP was exported), and control inflation.[100] Herein, the usage of "sterilization" mechanisms is what links the fixed exchange rate to the crux of China's monetary policy determinants.[101] As the sterilization process crowds out capital, the government creates a similar effect to a mere increase of interest rates- with the exception that domestic money demand is not altered, whereas money supply is being constantly distorted through government interventions.

Arguably up to today, China's policy has been serving its economic interest. They have managed to keep the inflation under reasonable control, exports have been increasingly competitive, and the economy has kept on expanding. At the same time, as they adopted the "policy of gradual renminbi appreciation" in 2005, the currency rose by 21% up to July 2008, and thus lowered the inflationary pressure quite successfully.[102] Additionally, the excess savings have yielded sufficient interest on global markets (see Table 5.1).[103] Hence, before the crisis hit, manipulating the exchange rate had an important role for China's economy in continuing the economy's expansion.

From the post-crisis perspective, however, the effects of a begged currency and the sterilization-policy may not be as clear anymore. Greenwood, for instance, argues that the budget surplus has "by any standard, [...] a very substantial magnitude, and will have large consequences for both China's trading partners as well as for China itself."[104] Scholars from China's Hunan University add to the idea with their statistical analysis on "China's implicit demand for foreign reserves" by concluding that in the long-run, "the neutralization policy leads to growth in foreign exchange reserves that seem limitless", which are "ultimately inconsistent."[105]

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[99] Mallaby, S. (2010).
[100] IMF. Principal Global Indicators: Goods: Exports: f.o.b. www.imf.org.
[101] For elaborate discussion over the sterilization process, see Wolf, M. (2008), p. 9.
[102] Bottelier, P., and Dadush, U. (March 2010).
[103] Greenwood, J (2008).
[104] Greenwood, J. (2008), p. 208.
[105] Tan, Z., Yang, S., and. Zhu, H (2008).

Table 5.1 Relative ratios of foreign reserves of China:[106]

	Foreign Reserves (million USD)	F/GDP	F/M2	F/Foreign debt	F (Weeks of imports)
1994	51,620	8.9%	9.5%	55.6%	23
1995	73,579	9.7%	10.1%	69.0%	30
1996	105,029	11.8%	11.5%	90.3%	41
1997	139,890	14.2%	12.7%	106.8%	53
1998	144,959	13.9%	11.5%	99.3%	56
1999	154,675	14.1%	10.7%	101.9%	50
2000	165,574	13.9%	10.2%	113.6%	40
2001	212,165	16.1%	11.1%	114.8%	47
2002	286,407	19.7%	12.8%	153.7%	52
2003	403,251	24.5%	15.1%	193.2%	53
2004	609,932	31.5%	19.9%	246.4%	59
2005	818,872	36.0%	22.5%	291.4%	67
2006	1,066,340	40.6%	24.6%	330.1%	73
2007	1,528,250	43.6%	26.7%	409.0%	86

Source: *International Financial Statistics.*

5.3 Post-Crisis

Today, according to Wai-chung Lo, and Michael C.M. Ng, as the recent credit crisis has posed the fragility of the "modern" financial system, there are no more models to set as an example- especially given that the Chinese financial system proved to be a lot more resilient during the crisis. At the same time, however, they also admit that the state controlled system creates "complex dynamics" among "the state management, and the board", which may cause inefficient governance, and thus harm the banks' ability to conduct their business effectively.[107]

Pro re nata, the authors note that as the financial crisis "is a recent demonstration of the opportunistic, manipulative behavior of bank managers", the Chinese-exercised state intervention might play a somewhat effective (disciplinary) role after all.[108] Ironically, this is supported by the fact that although the Anglo-Saxon liberal financial system has mostly been considered the financial role-model, the Chinese state controlled banking sector has proven greater resilience throughout the Great Recession. Albeit, if resilience is left aside, since it may be explained apart from the structure of the financial system (i.e. the amount of reserves available), cost efficiency of the semi-socialist financial model is still rather poor.

It is true that the reforms of China's monetary system have significantly improved the sector's performance. It is also true that throughout the credit crisis, the Chinese government control managed to maintain the

[106] The table was first presented by Tan, Z., S. Yang, and H. Zhu (2008), p. 94.
[107] Lo, W-C, and Ng, M. C. M. (2009), p. 37.
[108] Lo, W-C, and Ng, M. C. M. (2009), p. 38.

commercial banks' credit supply and thus protect China's businesses from global shocks better than most of the developed economies could. Nevertheless, as the non-performing loan rates are still high and the government continues subsequently to bail out the national commercial banks on a regular basis, it is not clear at all, whether the system's long-term sustainability is secure.[109]

S. Yao, Z. Han and G. Feng admit that the recent bank reforms, especially after China's accession to WTO in 2001, have brought about efficiency and decreased the problem of non-performing loans.[110] At the same time, they also point out that it is mainly the result of reducing government influence on active bank management. Paradoxically, this hints that although the recent crisis has undermined the credibility of the "western" financial industry, most of the increase in China's financial sector's efficiency is still related to gradually adopting the very same, arguably undermined, capitalist principles.[111]

6. Conclusion

Being carried by the spirit of Barth, Capri, and Levine who once stated that future research should "trace the forces shaping the evolution of bank regulations and supervision,"[112] the goal of this study has been to observe recent financial crisis' impact on the international willingness to enhance global financial regulations. More specifically, the central research question was stated to explore, whether the economic *status quo* incentivizes the creation of enhanced international financial regulations.

After choosing UK, USA, Germany, Japan, and China as the basis for this particular study, the goal has been to test the research question in the context of the five respective countries. Herein, 3 subject areas were chosen as gateways for a structured approach: regulatory reforms; an internationally distinguishing variable; and post-crisis conditions. In order to evaluate the findings with respect to the research question (whether there are incentives for enhance international financial regulations), conclusions will now be made about the international implications with regard to each gateway. Later, a general conclusion will follow.

First, regulatory reforms- a subject area that ended up circling dominantly around two terms: market liberalization and regulatory convergence. With regard to the two terms, several groups formed. Germany, Japan and United Kingdom, for example were similar with regard to the convergence trend. All of the three economies had either completely or to a great extent, merged the financial regulators into a single regulatory agency.

[109] For a discussion about the NPLs, see Lo, W-C, and M. C. M. Ng (2009), p. 21-24.
[110] Yao, S., Han, Z., and Feng, G. (2008).
[111] Yao, S., et al. (2008), p. 1310-1311.
[112] See footnote 1.

China's quasi-communist system could also qualify as a single authority regulating the financial markets. However, China has never had more than one regulator. Therefore, China's regulatory agency that is often intertwined with government's politics represents a separate category. And lastly, the United States, which has chosen not to merge regulatory agencies and therefore continues with system that other economies have abandoned.

At the same time, with regard to market liberalization, different types of groups have formed. The Anglo Saxon economies with their market-based financial systems stand somewhat separately from the bank-based German and Japanese systems. Herein, China is again a separate entity, as it has only recently chosen to move somewhat away from the fundamentally communist model. While solely observing the liberalization trend, however, all of the economies seem to be reconsidering the process of deregulation in response to the financial innovation that got out of control during the boom.

Second, the internationally distinguishing variables represented the variety of unique interests that every economy has in relation to international financial regulations. The Chinese fixed currency system creates considerable unbalances next to the large current account surplus that the country holds. With regard to Germany, its central role within Eurozone prescribes several international determinants that do not exist for Japan, for instance, which otherwise could be rather similar to the German bank-based system. Moreover, the current debt crises within Eurozone are a great example of the externalities that the German financial system must consider in order to secure itself a sustainable economic outlook in the long run.

The Japanese power decline is another example of unique determinants that Japan will most likely be driven by (both positively and negatively). The UK's and USA's common interest in their financial industries, however, is probably likely to provide a common ground for the financial powerhouses with initiating some key regulatory measures.

Third, the post-crises conditions which group the governments of Japan, UK, and USA due to their bailout packages, government stimulus plans, and subsequently looming national debt. Lastly, under the post-crises section, Germany and China stand somewhat close, as their current account surpluses keep on crowding out capital.

Therefore, over all, different areas interconnect the economies interests differently. With regard to the necessity to reduce budget deficits as well as to reverse the excessive deregulation, the economies appear to hold most of the common ground. However, China with its inherently different economic system, as well as the options that it holds to the foreign reserves and rather good ability to weather the crisis, stands out most separately.

Thus, while asking whether the five economies would be genuinely interested in enhanced global financial regulations, Germany, Japan, UK, and USA would most likely be incentivized more, although their own interests might in times conflict with each-other. China, however, with the fixed exchange rate policy and still continuing savings glut contribution, might not

be as clearly motivated. Nevertheless, since most of the Chinese economic power stems from global trade, it still must be interested in a stable environment. Therefore, although regulatory compromises might be most difficult to achieve with China, they should not be impossible.

In conclusion, while considering the probable benefits of the study, it has hopefully taken a step closer towards a more comprehensive grasp of the global financial system, and the multiplicity of denominators that underlie within the system.

Additionally, this study could be used for pursuing with a more precise depiction of the broad and perhaps somewhat vague scope that has been covered within this paper. Few of the many possible research directions will herein follow: a more accurate, concise and detailed assessment of these economic systems within the context of international economic cooperation; quantitative studies measuring the impacts of the gateways (i.e. measuring budget deficits, financial sector capitalization, financial market performance, interest rate movements, and other macroeconomic variables in relation to participation in international regulatory reform initiatives- e.g. the fulfillment of Basel Accord); focusing on explicit aspects within the study: i.e. banking sector performance across countries in comparison to the international regulatory commitments that countries have taken; etc.

All in all, since the topic of international financial regulations is broad and ambiguous, the ultimate goal of future research papers should be to isolate small, but comprehensive variables, and then study the changes with regard to the variables in a concise manner. Case studies certainly serve as healthy options for such a strategy- however, case studies as well, should, in my opinion, be designed as compact as possible in order to have hope for objective and clear conclusions.

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