

**FINANCIAL REGULATION AND THE
LOBBYING ACTIVITIES OF THE FINANCIAL SECTOR**

by Carlo Panico* and Antonio Pinto**

*(Incomplete and provisional draft.
Please do not quote without the authors' permission).*

Paper presented at the Conference on
“Reforming the Financial System: Proposals, Constraints and New Directions”
January 25-27, 2010, Muttukadu, Chennai, India

* Università di Napoli, Dipartimento di Economia, Via Mezzocannone, 16 – 80134 NAPOLI (ITALIA) – email: panico@unina.it

** Università di Napoli, Dipartimento di Scienze Statistiche, Via Rodinò, 22 – 80138 NAPOLI (ITALIA) – email: antpinto@unina.it

In the Introduction to a volume presenting the proceedings of a conference on financial regulation organised in April 2009 by Banca d'Italia and the Eurosystem, one can read:

Lobbying was not widely discussed at the workshop, which is a pity since a lot of clues point to a considerable activity by the “industry” in order to obtain favourable legislation, and more often to foil unfavourable legislation (Banca d'Italia, 2009, p. 11).

A large part of the economic literature on financial regulation disregards the ability of the financial sector to affect legislation. The difficulty to find information on this topic contributes to shifting the attention of the economists towards other aspects of the problem. Yet, it may be useful to draw the attention of the profession to the lobbying activity of this industry, which, as the previous quotation recalls, appears considerable. This activity may give some clues on why, since the 1970s, deregulation has moved hand in hand with a progressively increasing weight of the financial sector in the economy and with the acceleration of forms of innovation that are extremely complex and difficult to control.

The aim of this paper is to provide some arguments that may induce the profession to pay attention to these problems. The breakdown of Bretton Woods' agreements and the oil shocks of the Seventies changed the management of financial firms. Flexible exchange rates created new opportunities for financial operations while inflation and the decision of the authorities to attribute high priority to it accelerated financial innovation. These phenomena led to a progressive growth of the turnover of the financial sector, which strengthened its weight in the economy and may have favoured the introduction of legislation reducing the ability of the authorities to prevent the rise of systemic risk.

The paper also points out that in the USA, after the financial crises of the 1980s, there were attempts to re-regulate the financial system. They introduced forms of regulation, which, unlike those adopted during the so-called New Deal era, hinder the ability of regulators and of the monetary authorities to control the growth of the financial sector and the rise of systemic risk. The study of these attempts may contribute to clarifying what can affect legislation and what should be done to improve the stability of the system.

The paper is so organised. Sections 2-6 analyse an essay by White (2009), which describes the main tendencies in the evolution of financial regulation. They consider how the literature classifies the main forms of regulation and the theories behind White's interpretation, arguing that these theories, unlike those proposed by Minsky, Kaldor and Rousseas play down the role of lobbying activities. Section 7 adds some arguments suggesting that the lobbying activities of the financial industry may have contributed to the shift from a discretionary to a rules-based approach to regulation introduced by the legislation of the early 1990s. Section 8 gives some insights into the increased weight of the financial system in the economy. Section 9 draws some conclusions.

2. To describe the main tendencies in the evolution of financial regulation it may be useful to refer to a paper by White (2009), which summarises the history of regulation in the US since 1863. Comparing the legislation during the New Deal era with that prevailing afterwards, White (2009, p. 25) claims that the Great Depression led the Congress to adopt a new regulatory regime, which attributed considerable discretion to the authorities and underplayed the role of market discipline in stabilising the system. Since the Seventies, instead, legislation has been following a more complex path. De-regulation and a substantial reduction in supervision has been the dominant tendency. Yet, in the 1990s, after the banking and savings and loan's crises, de-regulation continued, but supervision was strengthened again. The forms of supervision then introduced differed from those of the New Deal era. Instead of following an approach based on the discretion and the independent evaluations of regulators, they have been following a rules-based approach, where actions automatically depend upon some statutory standards, which classify the banks according to categories defined through financial ratios calculated by dividing the value of risk-weighted assets to that of capital.

The New Deal era was characterised by great stability both in the real and in the financial sectors. According to White (2009, p. 32), the stability of the real sector promoted that of the financial sector, while the regulatory regime only played a secondary role in stabilising the economy. Supervision was based on the discretion

and the independent evaluations of the authorities. The other forms of regulation introduced barriers to entry, limited branching, merger and diversification, controls on pricing. Limitations on price competition compensated the constraints on the size of financial firms imposed by legislation and allow them to obtain satisfactory returns.

For White (2009, p. 31), this choice put firms under pressures and sowed the seeds of the distresses of the subsequent years:

This tight regulatory and supervisory regime helped to prevent bank failures, which as a percentage of all banks or deposits, fail to show up on the radar, as seen in Figure 3. The low failure rate and high return was, nonetheless, a consequence of a restrictive regime where competitive pressures were slowly building up (White, 2009, p. 39).

The rapid inflation of the 1970s accelerated the competitive pressures that had been slowly building up in the previous years. Bank crises increased in number and the authorities used their discretion by adopting forbearance towards failing banks and the “too big to fail” principle. This choice introduced perverse incentives, which led to further risk-taking and distress.

In the 1990s, as a consequence of the bank failures of the previous years, the Congress strengthened regulation. It introduced rules-based forms of supervision, which reduced the role of the discretionary evaluations of regulators. The new forms of supervision were backed up by enforcement powers. Yet, the amount of resources available to regulatory agencies had been reduced, since the Seventies, as part of a general plan to limit the size and the scope of the federal government in some fields. The result of this apparently contradictory evolution of legislation was a financial industry that grew in scale, scope and complexity, which the authorities scrambled to supervise:

The fast changing character of the financial system increased the challenge to federal bank supervisors, who had a relatively rigid rules-based statutory supervisory regime, who faced an increasingly complex and evolving banking system, adept at increasing risk (White, 2009, p. 37).

For White, the history of the US demonstrates that all forms of bank supervision, whether discretionary or rules-based, are bound to fail and that regulation must be based on market discipline. Deposit insurance and other measures that enhance the

moral hazard problem must thus be limited in order to raise the efficacy of the interventions in this field:

Looking over a century of bank supervision, one cannot be but dismayed by its failure to constrain risk-taking induced by deposit insurance and its rising cost. The resources of the regulatory agencies are finite and both discretion and rule-based supervision offer different perils. The least costly system was the National Banking Era but it is politically unlikely that we would revert to an uninsured bank regime; however, the inability of supervision to control risk-taking in any of the insured regimes suggests that deposits insurance must be limited to make supervision more effective by reintroducing more market discipline (White, 2009, p. 39)

3. White's position is an outstanding example of how a large part of the economic literature plays down the influence of lobbying activities on financial regulation.

Following Mishkin (2001), he describes nine different forms of regulation. Four of them (controls of entry, limits on economies of scale, limits on economies of scope and diversification, limits on pricing) can be used to reduce the degree of competition among financial firms. They can also be used, however, to affect the size and the structure of the sector and to control the quality of management and the exposure to risk of the individual firms. Other three (capital requirements, disclosure requirements and bank examination) can be used to enhance the ability of depositors and other operators to evaluate the behaviour of the managers. By reducing the degree of asymmetric information among those who offer and those who demand financial services, these forms of regulation tend to strengthen market discipline. Liabilities insurance is a form of regulation that aims at protecting depositors from the loss of their assets, thus reducing the probability of bank runs. The last form, supervision, aims at reducing the probability of systemic distress by assessing beforehand the 'management's exposure to risk. It may be discretionary or rules-based and it is enforced by the imposition of penalties' (White, 2009, p. 17). The extent to which supervision must be developed and the forms it must take depend on the view about the degree to which the market can be relied upon to solve the problems of asymmetric information (see White, 2009, p. 18).

During the New Deal era, when governments and the societies showed little faith in market discipline, legislation focused on discretionary supervision and on the first

four forms of regulation. It aimed at reinforcing the position of the authorities *via à vis* the financial sector by imposing limits to its size to avoid that it grew more than others and acquired a significant weight in the economy. At the same time, limitations on pricing (in the US in the form of interest ceilings¹) reduced competition among firms to guarantee their profitability. The strategy followed by this regulatory regime was consistent with that generally pursued by State intervention at the time. It tended to reduce conflicts in the society by integrating different interests and securing a consensual participation of as many sectors as possible in the benefits generated by the growth of the economy.

White's analysis overlooks these aspects of the history of financial regulation, which draw the attention of the analyst towards the relations between this industry and the authorities. Moreover, the analysis of these aspects suggests that the stability of the economy can be damaged if the growth of the financial sector supersedes that of the others. It can lead to policies that favour the interests of this sector at the expenses of those of the others and can bring about a situation in which 'speculation predominates over enterprise' (Keynes, 1936, p. 158).

4. Failing to acknowledge these aspects, White's (2009, p. 31) assessment of the working of regulation during the New Deal era underlines that the limits on competition built up pressures that accumulated for some decades within the financial firms. These pressures, he claims, exploded with the rapid inflation of the 1970s leading firms to increase risk-taking. By taking advantage of the protection of deposit insurance, they circumvent regulation and accelerate innovation in order to go pass the drop in profit and net worth. The Savings and Loan's crisis, White claims, was a consequence of this situation. Regulators and the authorities used their discretionary powers to put into practice forbearance and the "too big to fail" principle. This practice, however, was mistaken because it led 'to even larger failures' (White, 2009, p. 39) and then to legislation that reduced the role of discretionary evaluations and promoted forms of rules-based supervision. The results have been a financial industry

¹ In the UK and in Italy, the ceilings were set by banks' cartels with the implicit consent of the monetary authorities.

growing in scale, scope and complexity, which the authorities, in their attempts to control the systemic risk it generates, have found impossible to supervise.

White's position is in line with the dominant theories of financial innovation.² It captures important events of those years, playing down others, like the influence of restrictive monetary policies on innovation and that of lobbying activities on legislation. Following Silber (1975; 1983), Ben-Horim and Silber (1977), Kane (1981; 1983) and Van Horne (1985), he considers that the acceleration of innovation after the oil shocks was due to the rise in inflation (which raised the nominal interest rates and changed the operators' preferences) and to the constraints that regulation imposed on competition (which led financial firms to circumvent them to reduce costs). These theories consider financial innovation as firms' reactions to changes in preferences and conditions of production (induced by technical progress, improved knowledge on risk distribution and regulation). These reactions tend to eliminate "frictions" that prevent the system from working efficiently and to achieve higher levels of welfare. Financial innovation is thus seen as a positive phenomenon. Lobbying activities, when they are considered, are seen as a means to resist changes that favour efficiency, rather than as a means to affect the power relations with the authorities in order to increase the revenues of the sector regardless of what happens to systemic risk.³

In opposition to the dominant ones, Minsky (1957), Kaldor (1958; 1970) and Rousseas (1989) proposed a theory of financial innovation, which underlines that financial markets can generate forms of innovations that damage enterprise and the stability of the economy by increasing speculation and the systemic risk.⁴ Financial innovation is a positive phenomenon as long as it is properly regulated. The ability of the authorities to stabilise the system varies according to the historical circumstances. It depends on the relations of power prevailing in the society and on whether legislation endows the authorities with a high degree of technical independence and

² For a detailed description of these theories, see Fernandez Grela (1995).

³ Mishkin's (2001, p. 29), for instance, refers to Kroszner and Strahan (2001), which argues that private interests play a role in determining votes on banking regulation, to point out that small banks, the traditional beneficiaries of branching restrictions, tried to block interstate branching reform.

⁴ For a detailed description of these theories too, see Fernandez Grela (1995).

with the might to put into effect their decisions or allows the financial sector to escape controls. In this perspective, lobbying activities can hardly be disregarded.

5. As White points out, the limits on competition prevailing up to the 1970s did constrain the ability of financial firms to adjust to the situation generated by the oil shocks. Inflation raised the nominal interest rates, changing the cost of producing financial services, and affected the preferences of the operators. The outcome of this process was an acceleration of financial innovation that progressively set the firms free to improve their efficiency. Yet, the slowdown of the economy following the oil shocks and the decision of the authorities to set tighter controls on the money supply were important determinants of the acceleration of innovation too. These factors, disregarded by White, further constrained the turnover of financial firms leading them to innovate⁵, as suggested by the Keynesian theories.

In continental Europe too interest ceilings and other limits on competition were lifted after the oil shocks. Yet, legislation avoided depriving the authorities of their power to control financial firms and the stability of the system. In Italy, for instance, legislation promoted liberalisations and a substantial market-oriented reform of the financial structure. Yet, the system of controls and authorisations over entries, branching and economies of scope remained unchanged up to 1995 and, when it was reformed, it did not leave the authorities without a substantial power to authorise the development plans of financial firms.

The strategy followed by legislation in continental Europe after the oil shocks favoured the liberalisation of financial activities, but avoided leaving the authorities without substantial powers over financial firms. It was more attentive to the control of systemic risk than legislation in the USA, where de-regulation was attended, as White (2009, pp. 31 and 36) points out, by a reduction in supervision and a cut in the resources attributed to the authorities. Moreover, the general climate in which

⁵ White himself points out that during the “monetarist experiment”, ‘the percentage of unprofitable insured S&Ls rose from 7 per cent in 1979 to 85 per cent by 1981; and it is estimated that the whole industry was insolvent by \$100 billion. Commercial banks, pressured by competition and disintermediation and protected by rising levels of deposit insurance, similarly took on more risk’ (White, 2009, p. 32).

regulation was carried out became more favourable to firms.⁶ This climate may have induced the US authorities to apply forbearance and the “too big to fail principle” to a greater extent during the banking crisis of the 1980s. For White (2009, pp. 37 and 39), this choice was mistaken because it led to further banking crises. His paper, however, does not refer to analytical arguments to support this view, in spite of the central role it plays in his critique of discretionary supervision and in spite of the problems raised by the dismissal of the “too big to fail” principle in the case of the Lehman Brother.

6. According to White (pp. 36-38), the authorities’ misuse of discretionary powers during the banking and savings and loan’s crisis led legislation to promote rules-based supervision. The Federal Deposit Insurance Corporation Improvement Act of 1991 introduced this new regime, which prescribed a classification of banks according to five categories of risk exposure. When banks crossed certain thresholds, mandatory actions were taken that increased monitoring, restrictions and other remedies.

This regime imposed stricter obligations on financial firms, requiring them to comply with capital ratios and to provide for regulators an increased amount of information. Its results, however, was that the ability of firms to evade controls was enhanced:

However, by ruling out discretion, banks were able to develop new complex financial instruments that are not subject to statutory standards and allow them to assume more risk with existing capital. The most notorious of these were of course, the mortgage-backed securities that were held off-balance sheet in Structured Investment Vehicles (SIVs) that skirted the rules-based control system that was sufficiently rigid that it was difficult to quickly adjust to innovations. Banks were able to increase their risk and hence their return, while regulators appeared to be faithfully executing their mandates (White, 2009, p. 36).

Moreover, the constraints set on the budgetary and human resources of the regulatory authorities forced them to rely on the advice of Ratings Agencies, but the conflict of interest implied by the intervention of these entities further ‘weakened the ability of the bank regulatory agencies to adequately monitor banks’ (White, 2009, p. 37).

⁶ White (2009, p. 31) points out that, unlike what had happened before, the authorities’ rejection of bank’s charters became infrequent. Moreover, the Department of Justice under the Reagan administration eased opposition to horizontal mergers (see White, 2009, p. 32).

White (2009, p. 36) explicitly concludes that ‘the genesis of the most recent collapse has part of its root’ in the shift to the rules-based regime, which weakened the ability of the authorities to control financial firms and the rise of systemic risk.

7. For White the introduction in the 1990s of rules-based forms of regulation was a consequence of the problems caused by the relaxed standard applied by the authorities during the 1980s. There are elements however that suggest that other factors, including the lobbying activities of the financial industry, can also have played a relevant role in the formation of legislation.

Some literature points out that ruling out the authorities’ forbearance was not an argument shared by everybody in those years. Mishkin (2001), for instance, dealing with the relation between regulators and politicians, refers to a paper by Berger, Kyle and Scalise (2001), which argues that bank supervisors are not completely independent of political pressure by providing evidence that supervisors were tough during 1989-1992 and then relaxed standards during 1993-1998 because politicians claimed that supervisory actions were to blame for creating the “credit crunch” of the former period. The Federal Deposit Insurance Corporation Improvement Act of 1991 was thus introduced at a time when politicians criticised supervisors for being too tough, not for their relaxed standard.

The theoretical debate on monetary policy and the actions taken in the early 1990s moved in a direction opposite to that of the Federal Deposit Insurance Corporation Improvement Act. The failure of the monetarist experiment and the development of the “institutional design” literature⁷ promoted the view that in monetary policy competent and independent judgement works better than any conceivable rule:

Competent and dedicated policy-makers are better able than quantitative ceilings and rules to exercise good judgement and deliver the adequate mix of restraint and flexibility. To do so, however, they must be shielded from temptation and pressures that are part of political life (Wyplosz, 2002, p.14)

⁷ This literature was inspired by Rogoff (1985) trying to find a satisfactory solution to the dynamic inconsistency problem raised by Kydland and Prescott (1977). For an account of this literature, see Panico and Rizza (2004).

The large number of central banks' reforms implemented in those years recognises the malfunction of monetary rules and endows these institutions with a high degree of technical independence and with discretionary powers checked by transparency. The Federal Deposit Insurance Corporation Improvement Act contradicts this tendency since it replaces a rules-based for a discretionary approach to regulation. This contradiction raises doubts on White's interpretation and suggests that the formation of this piece of legislation was more complex and controversial than he proposes.

Finally, as Stiglitz (1998) points out, the authorities' independence, like the ability to control financial firms and the rise of systemic risk, takes different forms and degrees, which vary according to the historical circumstances. Kaldor (1970) claimed that the monetary authorities 'are in the position of a constitutional monarch: with very wide reserve powers on paper, the maintenance and continuance of which are greatly dependent on the degree of restraint and moderation shown in their exercise' (Kaldor, 1970, p. 196). He underlined that the authorities are aware of the precariousness of their leading position and take this element into account in their policy decisions to avoid adverse reactions from the firms they must lead and control and from the social and political worlds. He concluded that the maintenance of the authorities' position in the financial system is 'not a matter of legal powers, but of the avoidance of policies which would have led to the erosion of that role'. (Kaldor, 1970, p. 196).

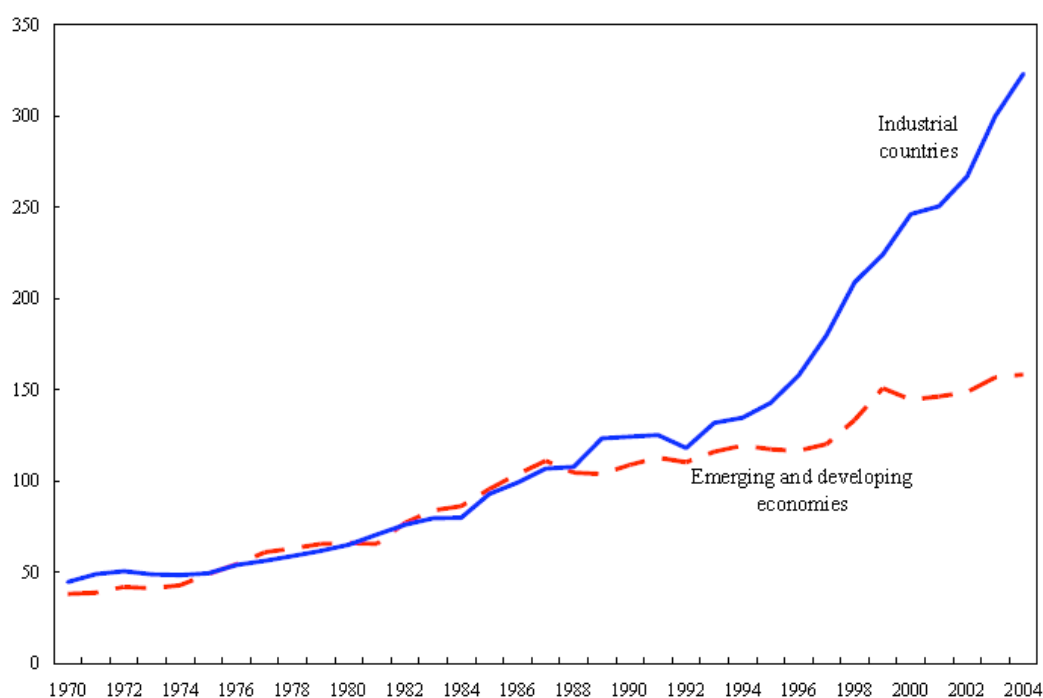
The complexity of Kaldor's approach to the formation of policy, to the problem of the authorities' independence, to financial innovation and to the formation of legislation on regulation makes it an interesting theoretical reference for examining the evolution of the system. It underlines that several opinions and preoccupations tend to affect the formation of legislation and direct towards interpretations that avoid reducing the role of power relations between the authorities and financial firms and recognise a the importance of lobbying activities.

8. In this section we add some further elements indicating a growing weight of the financial system in the economy after the breakdown of the Bretton Woods' agreements. This growing weight suggests an increasing lobbying ability of this

sector. In order to give some first insights into this subject we recall a few data and we refer to some results proposed by the recent literature.

According to data of the WTO, from 1977 to 2007 the international transactions on goods and services increased by 11 times. During the same years, transactions in the foreign exchange markets increased by 175 times.⁸ These transactions only include traditional products. If we add those on derivatives, the international financial transactions increased by 281 times from 1977 to 2007, even if we limit ourselves to the derivatives on exchanges and interest rates. This value, already extremely high, underestimates the growth of the turnover of financial firms, because the transactions on exchanges and interest rates are only a part of all transactions on derivatives. As the Bank of International Settlements points out, other transactions are carried out on derivatives on credits, equities and commodities. The latter in particular have grown in the last years at the highest rates.

Figure 1: Stocks of external assets and liabilities (% GDP)

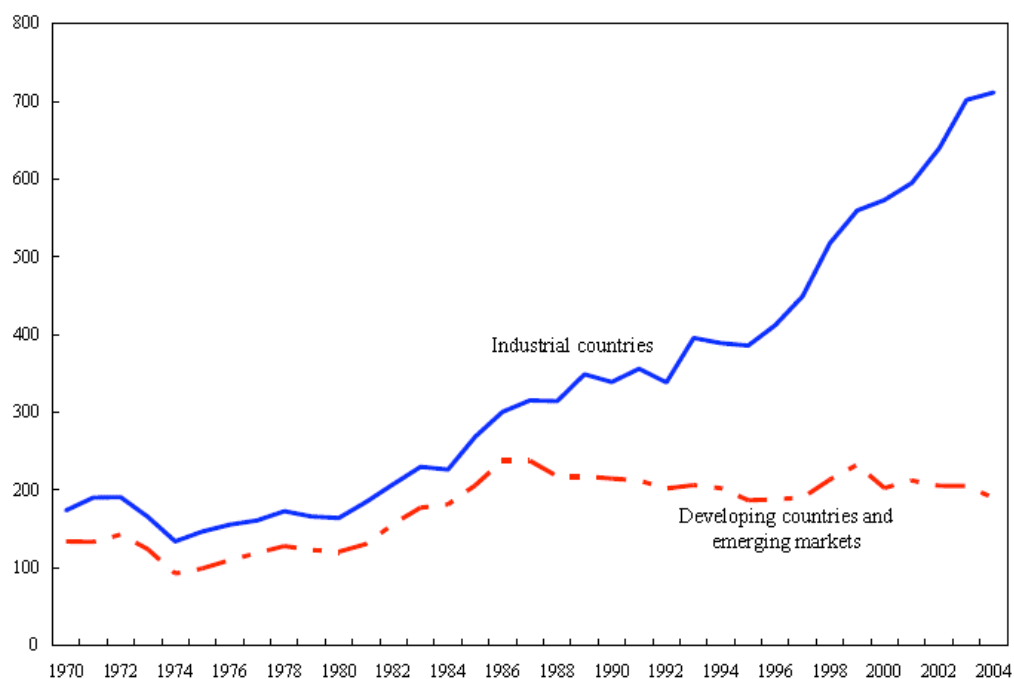


Source: Lane, Milesi-Ferretti (2006).

⁸ The data of the initial period are taken from Haq, Kaul and Grunberg (1996). The recent data are provided by the Triennial Reports of the Bank of International Settlements.

During the Bretton Woods era the role of international financial flows was limited to the funding of the international trade. Afterwards, foreign exchange markets have swollen well beyond the requirements of productive activities and international trade, as shown by Figures 1 and 2, which point out that over the period 1970-2004 the ratio “stocks of external assets and liabilities - GDP” in industrial countries moved from 45% to over 300%, while the ratio “stock of external assets and liabilities - international trade” rose from 180% to over 700%.

Figure 2. Stocks of external assets and liabilities (% international trade)



Source: Lane, Milesi-Ferretti (2006).

Crotty (2007) and Palley (2007) show that in USA the financial sector has increased its quota of GDP and of total profits with respect to the non-financial one. They point out that the share of the value added of the financial sector moved from 15% of 1973 to above 20% of 2005 (see Figure 3). The increase was greater in the 1980s and 1990s than in the 1970s, while the slower growth of the period 2000-2005 may reflect the 2001-2003 recessive business cycle in rich countries and the instability of financial markets that negatively affected the volume of international transactions after 2001.

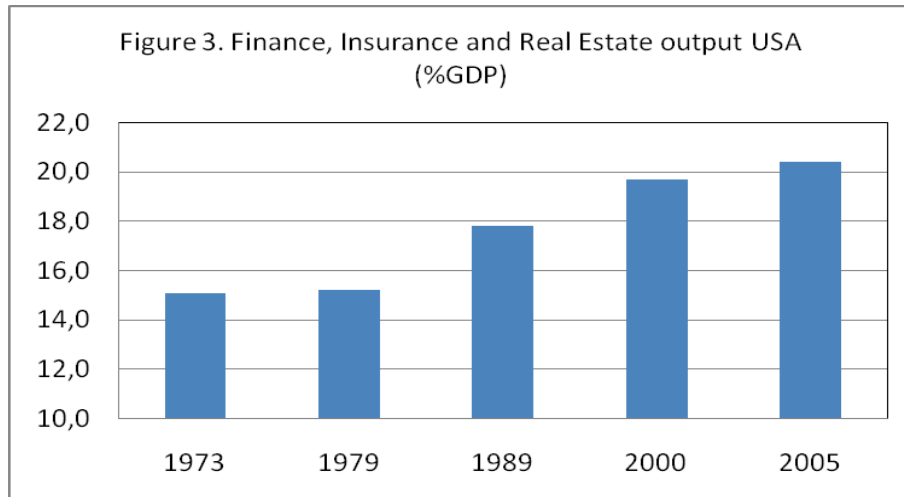
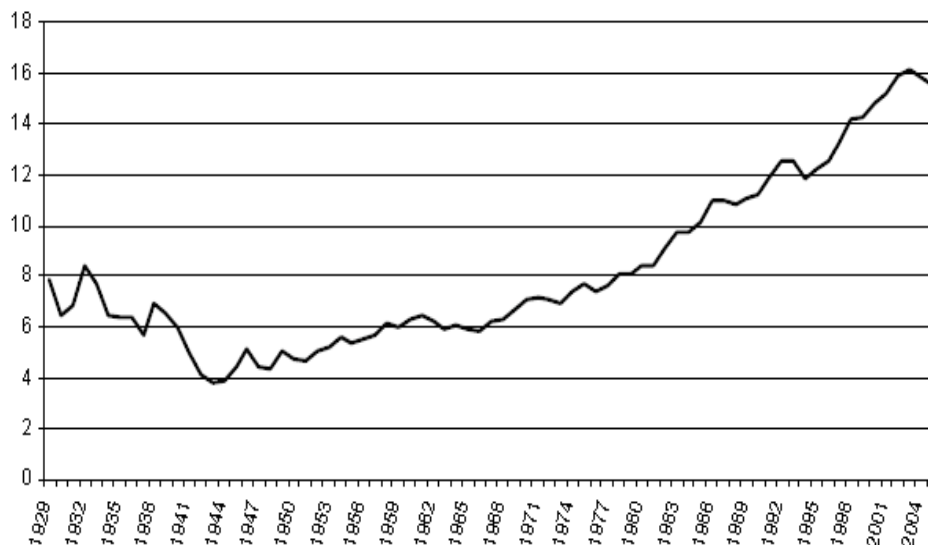


Figure 4 shows that the financial sector accelerated its growth after the 1970s with respect to the non-financial one, unlike what had happened before the 1970s.

Figure 4. Gross Value Added Financial Corporations (% Non-Financial Corporations)



Similarly, the profits of the financial sector show a steeper trend after the 1980s in absolute terms (see Figure 5) and with respect both to GDP (see Figure 6) and to the profits of the non-financial sector (see Figures 7). These trends shows some changes after 2002, in line with the slow down of the increase in the quota of the value added over GDP pointed out above.

Figure 5. Real profits of the Financial Sector

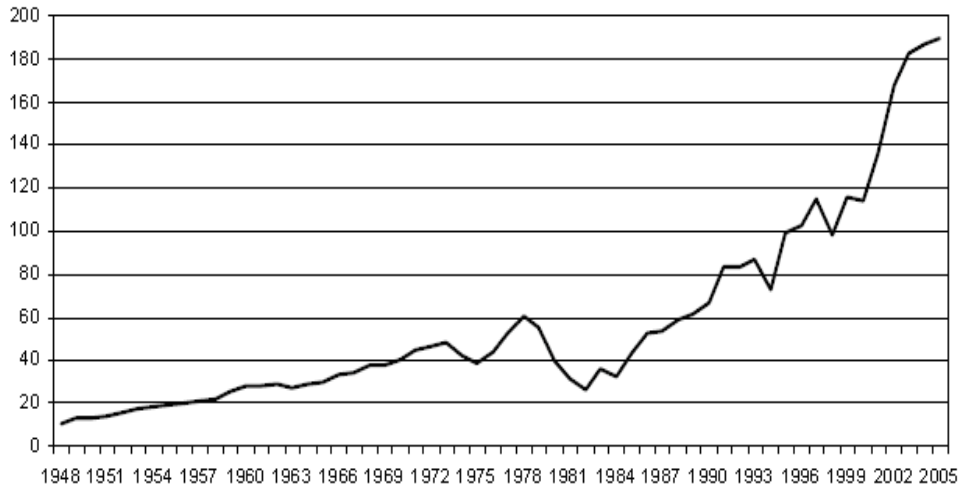


Figure 6. Financial sector profits (% GDP)

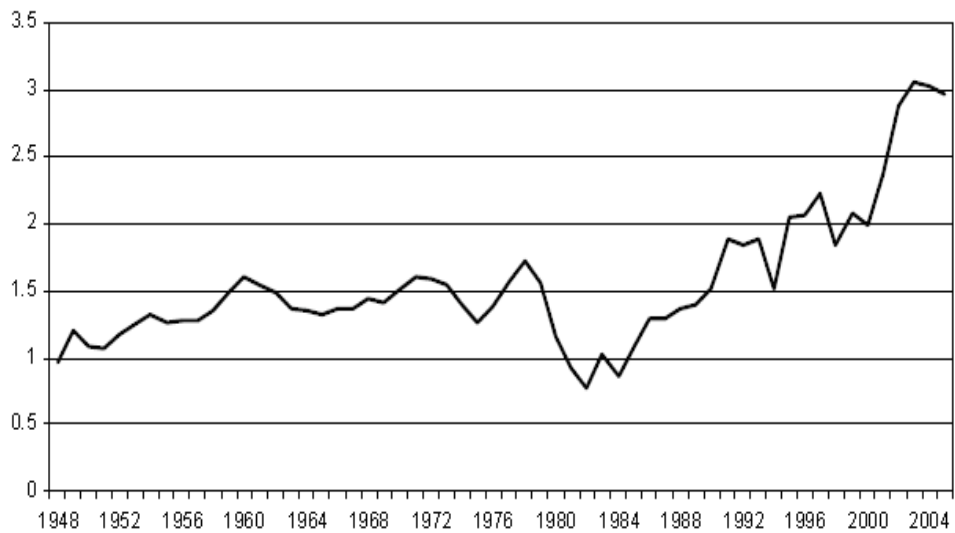
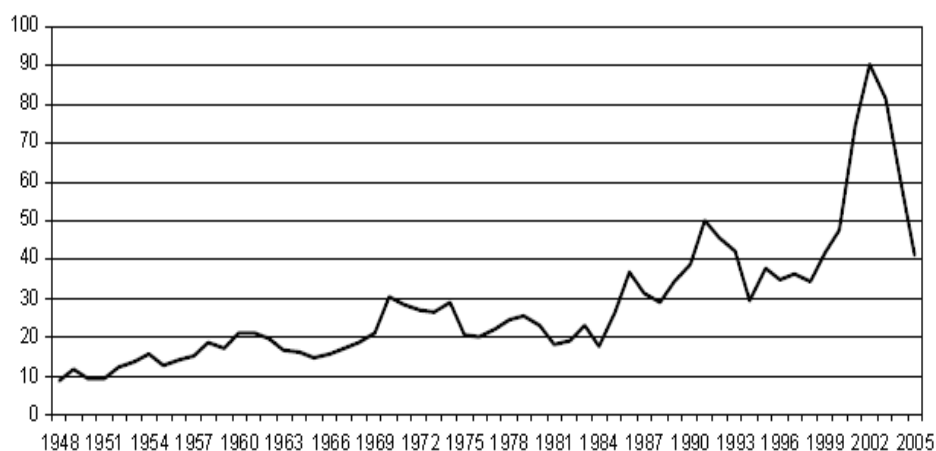


Figure 7. Financial Sector Profits (% Non-Financial Profits)



The analysis of Dumenil and Levy (2005) confirms the improved profitability of the financial sector since the 1970s. According to this analysis, in a long-run perspective the rates of profits of the financial and of the non-financial sector tend to move in the same direction. Yet, in the early 1980s, the rate of profit of the financial sector overtakes that of the non-financial sector and tends to remain higher, unlike what had happened during the previous three decades (see Figure 8).

Figure 8. Profit rates: Financial sector (—) and non-financial sector (- -). The two lines (.....) represent the trends.



Source: Dumenil-Levy (2005).

Finally, Dumenil and Levy (2005) points out (see Figure 9) that the gaps between the rates of profits of the two sectors have related to the movements of capital between them. The non-financial sector has attracted higher investments in the 1960s and the 1970s while the financial sector has attracted higher investments afterwards.

Figure 9. Ratio Net worth of the financial-sector-net worth non-financial sector (%).



Source: Dumenil-Levy (2005).

All these data confirm that the weight of the financial sector in the economy was constrained during the Bretton Woods (or New Deal) era, when regulation was based on the discretion of authorities endowed with a significant power to control financial firms. This period was also characterised by stability and lack of financial crises. Moreover, during this period, the profits of the financial sector were in line with, but not higher than, those of the other sectors of the economy.

After the Bretton Woods (or New Deal) era, the weight of the financial sector in the economy rose together with its turnover and profitability. The ability of the authorities to control financial firms weakened while legislation gradually changed towards a new approach. The recent collapse of the financial system, as White acknowledges, has part of its root in the shift to this rules-based regime.

These results suggest that the financial industry had an interest in lobbying in favour of the recent change of legislation and that it may have had an increased ability to do it. Further research are however necessary to validate this hypothesis.

9. Conclusions

A large part of the economic literature tends to play down the influence of the lobbying activities of the financial industry on regulation. It focuses on the attempts of financial firms to resist the changes towards the efficiency induced by competition in order to avoid losing the privileges that regulation guarantees to them. Other literature, related to the work of Minsky, Kaldor and Rousseas, considers instead that the lobbying activities of the financial industry is also directed to reducing the effectiveness of the controls of the authorities in order to introduce forms of innovation that increase the turnover of financial firms, but also systemic risk.

White (2009) is an example of the first kind of literature. It presents an important reconstruction of the US history of regulation by paying limited attention to lobbying activities. Its interpretation of the results achieved by regulation during the New Deal era overlooks that legislation at the time aimed at reinforcing the position of the authorities *via à vis* the financial sector by avoiding that the growth of this sector could supersede that of the others and put at risk the stability of the economy. It disregards that the slowdown of the economy following the oil shocks and the decision of the authorities to set tighter controls on the money supply were also important determinants of the acceleration of innovation and of the banking crises of the 1980s and that in those years the ability of the authorities to control financial firms was limited by the fact that the general climate in which regulation was carried out became more favourable to them. Finally, it disregards that in the 1990s the change from a discretionary to a rules-based approach to regulation contradicts both the view, prevailing in those years, that competent and independent judgement works better than any conceivable rule and the tendency in legislation to endow the authorities with discretionary powers and a high degree of technical independence.

On financial ratios and capital requirements White (2009, p. 27) rightly points out that in a discretionary approach they are regarded by supervisors as guidelines of risk exposure and that the authorities emphasise the need for discretion because “a well-managed bank, free of asset problem, is entitled to operate on a higher leveraged

capital base than one which has asset problems”. He also points out that the transformation of financial ratios from guidelines to compulsory prescriptions led the firms to introduce forms of innovation circumventing these rules (see White, 2009, pp. 32-33 and 36). ‘Off-balance sheet business grew considerably’ (White, 2009, p. 33) because they had the ability to circumvent these statutory standards. Yet, for him, the introduction in the 1990s of rules-based forms of regulation was the result of the problems caused by the relaxed standard applied by the authorities during the 1980s, rather than the consequence of the ability of the financial industry to divert legislation, initially inspired by political actions aiming at controlling the rise of systemic risk, towards forms of regulation with limited effectiveness.

References

- Banca d'Italia - Eurosystem, 2009, Gigliobianco A., Introduction. Regulatory responses to financial crises. In search of a pattern, in Gigliobianco A. and Toniolo G., eds., *Financial Market Regulation in the Wake of Financial Crises: The Historical Experience*, Workshops and Conferences, November, 9-12.
- Ben-Horim M. and Silber W.L., 1977, Financial innovation: a linear programming approach, *Journal of Banking and Finance*, 1. ...
- Berger, Kyle and Scalise, 2001, In Mishkin F.S., ed., *Prudential Supervision. What Works and What Doesn't*, National Bureau of Economic Research Working Paper Series, n. 7926, ...
- BIS (2007), Triennial Central Bank Surveys, Foreign exchange and derivatives market activity in 2007.
- Crotty, J. (2007), If Financial Market Competition is so Intense, Why are Financial Firm Profits so High? Reflections on the Current ‘Golden Age’ of Finance, *PERI, Working Paper Series* n.134.
- Dumenil, G., Levy, D. (2004), The Real and Financial Components of Profitability (USA 1948-2000), *Review of Radical Political Economy*, Vol.36, pagg.82-110.

- Fernandez Grela M., 1995, *La Innovacion Financiera y sus Interpretaciones: un Punto de Vista Keynesiano*, Tesis Doctoral, Universidad de Santiago de Compostela, España.
- Kaldor N., 1958, Monetary policy, economic stability and growth, *Memorandum for the Committee on the Working of the Monetary System*, in *Essays on Economic Policy*, Volume I, Chapter 6, Duckworth, London, 1964, 128-153.
- Kaldor N., 1970, The New Monetarism, *Lloyds Bank Review*, 97, July, 1-17, reprinted in Musella M. and Panico C., eds., *The Money Supply in the Economic Process*, Elgar, Aldershot, 1995, 188-204.
- Kane E.J., 1981, Accelerating inflation, technological innovation, and the decreasing effectiveness of banking regulation, *Journal of Finance*, 36 (2),
- Kane E.J., 1983, Policy implications of structural changes in financial markets, *American Economic Review*, 73 (2),
- Keynes J.M., 1936, *The General Theory of Employment, Interest and Money*, Macmillan, London.
- Kroszner and Strahan, 2001, In Mishkin F.S., ed., *Prudential Supervision. What Works and What Doesn't*, National Bureau of Economic Research Working Paper Series, n. 7926, ...
- Kydland F. E. and Prescott E. C., 1977, Rules rather than discretion: the inconsistency of optimal plans, *Journal of Political Economy*, 85 (3), June, 473-91
- Lane, P.R., Milesi-Ferretti, G.M. (2006), The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004, *IMF Working Paper WP/06/69*.
- Minsky H.P., 1957, Central banking and money market changes, *Quarterly Journal of Economics*, 71 (2), ...
- Mishkin F.S., 2001, Prudential supervision: why is it important and what are the issues? In Mishkin F.S., ed., *Prudential Supervision. What Works and What Doesn't*, National Bureau of Economic Research Working Paper Series, n. 7926, 1-36.
- Palley, I.T. (2007), Financialization: What it is and Why it Matters, paper presented at conference on “*Finance-led Capitalism? Macroeconomic Effects of Changes in the Financial Sector*”, Berlin.
- Panico C. and Rizza M.O., 2004, Central bank independence and democracy: a historical perspective, in Arena R. and Salvadori N., eds., *Money, Credit and*

the Role of the State: Essays in Honour of Augusto Graziani, Ashgate, London, 447-67.

Rogoff K., 1985, The optimal degree of commitment to an intermediate monetary target, *Quarterly Journal of Economics*, 100 (4), November, 1169-89.

Rousseas S., 1989, *Post-Keynesian Monetary Economics*, Macmillan, London.

Silber W.L., 1975, Towards a theory of financial innovation, in Silber W.L., ed., *Financial Innovation*, Chapter 2, D.C. Heath, Lexington, ...

Silber W.L., 1983, The process of financial innovation, *American Economic Review*, 73 (2), ...

Van Horne J.C., 1985, On financial innovation and excesses, *Journal of Finance*, 40 (3) ...

White E.N., 2009, Lessons from the history of bank examination and supervision in the United States, 1863-2008, in Gigliobianco A. and Toniolo G., eds., *Financial Market Regulation in the Wake of Financial Crises: The Historical Experience*, Workshops and Conferences, November, 15-44.

Wyplosz C., 2002, Fiscal discipline in EMU: rules or institutions?, mimeo, http://hei.unige.ch/~wyplosz/gea_0402.pdf