Anglo-German Foundation for the Study of Industrial Society

The Anglo-German Foundation for the Study of Industrial Society was established by an agreement between the British and German governments after a state visit to Britain by the late President Heinemann, and incorporated by Royal Charter in 1973. Funds were initially provided by the German government; since 1979 both governments have been contributing.

The Foundation aims to contribute to the knowledge and understanding of industrial society in the two countries and to promote contacts between them. It funds selected research projects and conferences in the industrial, economic and social policy areas designed to be of practical use to policy-makers.

Titles include:

Bernhard Blanke and Randall Smith (*editors*)

CITIES IN TRANSITION

New Challenges, New Responsibilities

John Bynner and Rainer K. Silbereisen (*editors*)

ADVERSITY AND CHALLENGE IN LIFE IN THE NEW GERMANY AND
IN ENGLAND

Maurie J. Cohen (*editor*)

RISK IN THE MODERN AGE

Social Theory, Science and Environmental Decision-Making

Dagmar Ebster-Grosz and Derek Pugh (*editors*)

ANGLO-GERMAN BUSINESS COLLABORATION

Pitfalls and Potentials

Rainer Emig (*editor*)

STEREOTYPES IN CONTEMPORARY ANGLO-GERMAN RELATIONS

Karen Evans, Martina Behrens and Jens Kaluza

LEARNING AND WORK IN THE RISK SOCIETY

Lessons for the Labour Markets of Europe from Eastern Germany

Stephen F. Frowen and Jens Hölscher (*editors*)

THE GERMAN CURRENCY UNION OF 1990

A Critical Assessment

Eva Kolinsky (*editor*)

SOCIAL TRANSFORMATION AND THE FAMILY IN
POST-COMMUNIST GERMANY

Mairi Maclean and Jean-Marc Trouille (*editors*)

FRANCE, GERMANY AND BRITAIN

Partners in a Changing World

Howard Williams, Colin Wight and Norbert Kapferer (*editors*)

POLITICAL THOUGHT AND GERMAN REUNIFICATION

The New German Ideology?

Anglo-German Foundation

Series Standing Order ISBN 978-0-333-71459-1

(outside North America only)

You can receive future titles in this series as they are published by placing a standing order. Please contact your bookseller or, in case of difficulty, write to us at the address below with your name and address, the title of the series and the ISBN quoted above.

Customer Services Department, Macmillan Distribution Ltd, Houndmills, Basingstoke, Hampshire RG21 6XS, England

Financial Competition, Risk and Accountability

British and German Experiences

Edited by

Stephen F. Frowen

Fellow Commoner

St Edmund's College

Cambridge, and

Honorary Professor

Institute for German Studies

The University of Birmingham

and

Francis P. McHugh

Emeritus Fellow

St Edmund's College

Cambridge

palgrave
macmillan

in association with
Anglo-German Foundation
for the Study of Industrial
Society

Selection and editorial matter © Stephen F. Frowen and Francis P. McHugh 2001

Chapter 9 © Stephen F. Frowen and Elias Karakitsos 2001

Chapters 1–8, 10–16 © Palgrave Publishers Ltd 2001

Softcover reprint of the hardcover 1st edition 2001 978-0-333-73590-9

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No paragraph of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, 90 Tottenham Court Road, London W1P 0LP.

Any person who does any unauthorised act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

The authors have asserted their rights to be identified as the authors of this work in accordance with the Copyright, Designs and Patents Act 1988.

First published 2001 by
PALGRAVE

Houndmills, Basingstoke, Hampshire RG21 6XS and

175 Fifth Avenue, New York, N. Y. 10010

Companies and representatives throughout the world

PALGRAVE is the new global academic imprint of
St. Martin's Press LLC Scholarly and Reference Division and
Palgrave Publishers Ltd (formerly Macmillan Press Ltd).

Outside North America

ISBN 978-1-349-65238-9

ISBN 978-1-349-65236-5 (eBook)

DOI 10.1007/978-1-349-65236-5

In North America

ISBN 978-0-312-23466-9

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available
from the British Library.

Library of Congress Cataloging-in-Publication Data

Financial competition, risk and accountability : British and German experiences / edited by Stephen F. Frowen and Francis P. McHugh ; in association with Anglo-German Foundation for the Study of Industrial Society.

p. cm.

Includes bibliographical references and index.

1. Financial institutions—Great Britain. 2. Financial institutions—Germany. 3. Competition—Great Britain. 4. Competition—Germany. 5. Risk. I. Frowen, Stephen F. II. McHugh, Francis P. III. Anglo-German Foundation for the Study of Industrial Society.

HG186.G7 F545 2000

332.1'0941—dc21

00-027828

10 9 8 7 6 5 4 3 2 1
10 09 08 07 06 05 04 03 02 01

Contents

<i>List of Tables and Figures</i>	vii
<i>Notes on the Contributors</i>	ix
<i>Introduction</i>	xvii
<i>Acknowledgements</i>	xxiv
1 Competition Forces and Institutional Structure in the UK and Germany <i>Norbert Walter</i>	1
2 Alternative Routes to Banking Stability: A Comparison of UK and German Banking Systems <i>Glenn Hoggarth, Alistair Milne and Geoffrey E. Wood</i>	11
3 European Destiny and Macroeconomic Responsibility in the Financial Systems of Germany and the UK: A Balance-Sheet Approach <i>Jan Toporowski</i>	33
Discussant's Comments <i>Andrew Tylecote</i>	50
4 What Kind of Stability Helps Industry? Contrasting Experiences with British and German Banking <i>Forrest H. Capie and Geoffrey E. Wood</i>	58
Discussant's Comments <i>Benedikt Koehler</i>	70
5 Financial Competition, Risk and Accountability: The Role of Trust Banks <i>Jan A. Kregel</i>	74
6 The Dynamics of Change and Risk in Corporate and Wholesale Finance <i>Barry Howcroft</i>	94
Discussant's Comments <i>Bernd Zugenbühler</i>	111

7	Risk Management and the Ethics of New Financial Instruments <i>Justin Welby</i>	119
8	Business Ethics in the Banking Industry: Some Remarks <i>Andreas Wagner</i>	136
9	The Savings-Ratio Behaviour in Globalised Money and Capital Markets: A Comparison of the UK and German Experiences <i>Stephen F. Frowen and Elias Karakitsos</i>	146
10	The Conduct and Ethical Underpinnings of Monetary Policy in the United Kingdom and Germany <i>Eric Owen Smith</i>	169
11	The Role of Central Banks in a Global Competition Environment <i>Norbert Kloten</i>	189
12	Bank Supervision in the Context of Global Competition <i>John G. Ellis</i>	206
13	Economic and Monetary Union: An Ethical Issue? <i>Martin Donnelly</i>	212
14	Capital and Credit-Based Development: Lessons from the Experience of Industrial Countries for Transition Economies in Central East Europe <i>Stephan Herten and Jens Hölscher</i>	225
	Discussant's Comments <i>Matthias Moersch</i>	251
15	Social Banking and Affordable Housing in Germany: the Example of an Inclusive Bank Product <i>Udo Reifner and Juliane Pfau</i>	257
16	The Role of Compliance in Germany's Banking Culture <i>Leo Schuster</i>	292
	<i>Author Index</i>	305
	<i>Subject Index</i>	309

List of Tables and Figures

Tables

2.1	Recent banking problems in major economies	13
2.2	Standard deviation of annual growth in real asset prices and credit/GDP, 1971–97	16
2.3	Correlations of annual growth in credit/GDP and real asset prices	17
2.4	Shares of assets – December 1997	18
2.5	Profit and loss accounts	20
3.1	Summary table of flows, Germany and UK (by sector, %)	42
6.1	International financial activity (US\$ bn)	100
6.2	Percentage of net funds raised by non-financial companies	105
9.1	The personal-sector balance sheet	154
9.2	The UK personal-sector balance sheet, end of 1990	155
14.1	Indicators of commercial bank liabilities and receivables from the national bank in the Czech Republic, Hungary and Poland, 1989–94	233
A14.1	Hungary: empirical findings, 1992–94	241
A14.2	Poland: empirical findings, 1986–93	244
A14.3	Slovakia: empirical findings	246
A14.4	Czech Republic: empirical findings	247

Figures

6.1	Revolving underwritten facility (RUF)	102
6.2	Note issuance facility (NIF)	103
6.3	Euro commercial paper (ECP)	103
6.4	Hypothetical example of costs associated with euronotes and conventional bank borrowing	104
6.5	Banks' profits and the economic cycle	107
6.6	Bank loan interest rate dependence on risk	112
8.1	Levels of frameworks for economic and ethical behaviour	138
8.2	Restructuring ethical problems of banks in three dimensions	139

8.3	Motives for the implementation of an ethics programme in banks	140
8.4	Aspects of an ethics management in banks	142
9.1	UK personal savings ratio in business cycles	157
9.2	The personal-sector financial balance	158
9.3	Personal-sector net wealth–income ratio	159
9.4	Personal-sector debt burden	160
9.5	House price–earnings ratio	161
10.1	German cyclical behaviour patterns	186
14.1	Capital markets, interest rates and credit creation	235
14.2	Liberalisation and bad-debt solutions	239

Notes on the Contributors

Forrest H. Capie is Professor of Economic History at City University Business School, London. After a doctorate at the London School of Economics in the 1970s and a teaching fellowship there, he taught at the University of Warwick and the University of Leeds. He has published widely in the fields of money, banking and international trade – around 100 articles and almost 20 books. He has been a British Academy Overseas Fellow at the National Bureau, New York, and for the past seven years has been editor of the *Economic History Review*.

Martin Donnelly is a UK Treasury civil servant, at present Deputy Head of the European Secretariat of the Cabinet Office. He studied at Oxford University, the College of Europe, Bruges and the École National d'Administration in Paris. He spent four years on secondment to the European Commission in Brussels, in the Cabinet of Sir Leon Brittan, and has also worked in the French Tresor.

John G. Ellis joined the Bank of England in 1978 and worked on a wide variety of subjects, including international debt, the Euromarkets, UK money markets and finance for industry. He was later responsible for the supervision of all North American banks operating in the UK until in 1998, he was appointed to the new Financial Services Authority as Head of the Japan, Australasia, North America and Europe Department. He also serves as the FSA's Business Ethics Adviser. An Elder of the United Reformed Church, he is a director of three companies with community and charitable objectives.

Stephen F. Frowen is a Fellow of St Edmund's College, Cambridge, Senior Research Associate of the Von Hügel Institute, Honorary Professor at the Institute for German Studies, University of Birmingham, and Honorary Research Fellow in the Department of Economics, University College London. He was formerly Bundesbank Professor of Monetary Economics in the Free University of Berlin. Prior to this appointment he was Visiting Professor at the Universities of Würzburg and Frankfurt, and for many years held senior teaching posts at the Universities of Greenwich and Surrey, following appointments as Research Officer at the National Institute of Economic and Social

Research, London, as Economic Adviser to the Industrial and Commercial Finance Corporation (now 3i) and as Chief Editor of *The Bankers' Magazine* (now *Financial World*). In 1980–1 he served as Special Adviser to UNIDO, Vienna. He has published widely in monetary and macro-economics and in banking. He is the editor of many collective works and a Contributing Editor of *Centre Banking*. In 1993 he received the Grand Cross of the Order of Merit of the Federal Republic of Germany, and in 1996 was honoured with a Papal Knighthood of the Pontifical Order of St Gregory the Great.

Stephan Herten is a PhD candidate at the Institute for German Studies at the University of Birmingham, concentrating on monetary policy within different financial systems. He previously held a temporary lectureship at the University of Leeds Business School. He studied at the universities of Heidelberg, Bonn and Berlin (Freie Universität), where he subsequently took up an appointment as research fellow. He has published in the areas of transition economics, input–output analysis and federalism.

Glenn Hoggarth graduated in economics at Warwick University and gained a MA degree at Cambridge University. He joined the Economics Division of the Bank of England in 1989, advising mainly on UK monetary policy, after seven years as a private sector economist. Between 1994–6 he was Adviser on Monetary Policy at the Bank's Centre for Central Banking Studies and an IMF external adviser on monetary operations and policy in Eastern and Central Europe and Asia. Since 1997 he has been working in the Bank's Financial Stability area — first as Senior Economist in the Financial Intermediaries Division and currently in the Regulatory Policy Division.

Jens Hölscher is Senior Lecturer at the University of Brighton. Previously he served as Senior Fellow at the University of Birmingham and as Lecturer at the University of Wales, Swansea, and at the Free University of Berlin. He held Visiting Professorships at the Halle Institute for Economic Research, Chemnitz University and the Kazakhstan Institute for Management, Economics and Strategic Research. Publications concentrate on monetary and transition economics.

Barry Howcroft is Professor of Retail Banking and Director of Loughborough University Banking Centre. He was previously employed by

National Westminster Bank and has experience of corporate banking in both domestic and international banking. He is an Associate of the Chartered Institute of Bankers and an assessor for the Quality Assurance Agency for Higher Education. He has lectured extensively throughout the UK, Europe and the Middle East and is a management consultant for several major banks and building societies. His main research interests are in the area of strategies in retail banking, and within this field he has published extensively on delivery channels, quality of service, customer retention and branch efficiency. He has written a large number of articles and is the author of, and contributor to, 20 books on banking. In 1992 he received the Literati Club award for excellence for the most outstanding paper, and in 1997 he received the most outstanding paper award.

Elias Karakitsos is Professor of Economics and Head of the Economics Section at the Management School, Imperial College, London, where he has pioneered research on the design of economic policy and has been a principal investigator in the programme of research into Optimal Policy Evaluation run by Imperial College since the early 1980s. Since 1987 his research interests have shifted from economic policy to financial markets. He is currently Chief Economic Adviser to the Strategy Committee of Citibank/Citicorp, Europe and USA, an Adviser to Abbey National, Kredietbank, Belgium, Oppenheimer International Capital Markets, New York, and Chief Economic Adviser to the European Commission. Previously he worked as an economic consultant responsible for analysing the German economy through large-scale econometric models. He has published widely in the area of economic policy and asset price volatility and determination. His book on *Macrosystems: The Dynamics of Economic Policy* was published in 1992.

Norbert Kloten was President of the Land Central Bank in Baden-Württemberg and an *ex officio* member of the German policy-making Central Bank Council from 1976 to 1992. Since 1967 he has been a member of the Economic Advisory Council at the Federal Ministry of Economics (Chairman from 1992 to 1996). Other activities include membership of the Board of Academic and Non-Academic Associations and the Trilateral Commission. His Professorship at the University of Tübingen (1960–76) was combined with membership of the German Council of Economic Experts (Sachverständigenrat) from 1969 to 1976, being its Chairman from 1970–6. He has published extensively on the

principles of economic policy and in the area of monetary and international monetary economics, on the theory and policy of transition and development, and on the methodology of economics. He holds two honorary doctorates from the University of Karlsruhe (1980) and the University of Stuttgart (1993) respectively, and is the bearer of the Commander's Cross with Badge and Star of the Order of Merit of the Federal Republic of Germany.

Benedikt Koehler, General Manager of the London Branch of the Norddeutsche Landesbank, attended Yale University and took his doctorate at the University of Tübingen. He is the author of a biography of Ludwig Bamberger (1999).

Jan Kregel is Professor of Economics at the University of Bologna (Italy). He is the author of several books and numerous articles in the field of economics.

Francis P. McHugh, a Catholic priest and political economist, is Director of the Von Hügel Institute of St Edmund's College, Cambridge, where he is resident Emeritus Fellow. He read PPE at Oxford and the Diploma in Political Economy. He was awarded his PhD by the University of Cambridge. His recent publications include *A Keyguide to Resources in Business Ethics* (1988); *Things Old and New: Catholic Social Teaching Revisited* (edited jointly with Sam Natale) (1993); and *Financial Decision-Making and Moral Responsibility* (edited jointly with Stephen F. Frowen) (1997). He is also a member of the editorial board of *International Journal of Value-based Management*, *La Societa* and *Ethical Perspectives* (University of Leuven).

Alistair Milne holds an MA in economics from the University of Cambridge and a PhD from the London School of Economics. He is currently Senior Lecturer in Banking and Finance at City University Business School. His research interests include banking competition and performance, bank regulation, and links between financial markets and the macro economy. In the past he has been an economic adviser at the Bank of England, a lecturer at the University of Surrey, a research fellow at London Business School, an economic assistant at HM Treasury, and has worked for the government of Malawi.

Mathias Moersch is currently Senior Economist with Dg Bank, Deutsche Genossenschaftsbank AG in Frankfurt/Main. He holds a PhD

in economics from the University of North Carolina at Chapel Hill, and is the co-editor of *Competition and Convergence in Financial Markets*.

Eric Owen Smith is Senior Lecturer in Economics at Loughborough University, a Visiting Professor at the University of Trier and a Visiting Fellow of the Institute for German Studies at The University of Birmingham. His research interests are in German economic performance and comparative studies of collective bargaining in Germany and Britain. As well as numerous publications in these fields, he has written the definitive English study on *The German Economy* (1994). He is also an independent chair of the Appeals Committee of the Open University, an ACAS arbitrator and a member of Industrial Tribunals.

Juliane Pfau is a Senior Research Officer at the Institute for Financial Services (IFF e.v.) in Hamburg and since 1999 has been at the University of Colorado with a research grant from the Friedrich Ebert Foundation.

Udo Reifner is Director of the independent Institute for Financial Services (IFF e.v.) and has been Professor of Commercial Law at the University of Hamburg since 1981. He was a Guest Professor of Commercial Law at McGill University, Montreal (1976), the Université de Louvain-la-Neuve in Belgium (1990), De Paul University in Chicago (1994), Birmingham University (1997) and New York University (2000). He has published extensively in the fields of banking law, sociology of law, history of law, legal theory, financial services, consumer protection and social economy. Recent books include *Credit and New Entrepreneurs* (1998); *Community Reinvestment* (1998); and *Social Responsibility of Banks in the European Community* (1998).

Leo Schuster is Professor of Banking and Finance at the Catholic University of Eichstätt in Ingolstadt (Germany). He was previously Professor of Banking and Director of the Banking Institute at the University of St Gallen in Switzerland and Visiting Professor at the University of Lausanne. In 1998 he held a Visiting Fellowship at the Von Hügel Institute, St Edmund's College, Cambridge. His extensive publications in the area of banking include strategic planning, marketing, intercultural management, banking systems and organisation. He is a member of the board of directors of a Zürich-based international bank and a major insurance company in Germany and an adviser to several

financial institutions. Professor Schuster is also the Chairman of the German Compliance Association in Frankfurt and co-editor of banking journals in Germany, Switzerland and Belgium institutions.

Jan Toporowski has worked in fund management, international banking and economic consultancy, and is currently Reader in Economics at South Bank University. He is the author of *The Economics of Financial Markets and the 1987 Crash* (Edward Elgar, 1993) and *The End of Finance: The Theory of Capital Market Inflation, Financial Derivatives and Pension Fund Capitalism* (Routledge, 2000).

Andrew Tylecote is Professor of Economics and Management of Technological Change at the University of Sheffield. He was educated at Sussex and Oxford in philosophy, economics, politics and sociology. His most recent book was *The Long Wave in the World Economy: The Present Crisis in Historical Perspective* (Routledge). From 1992–8 he was Treasurer of the European Association for Evolutionary Political Economy. He is currently coordinating a six-country EC-funded project on Corporate Governance, Performance and Product Innovation.

Andreas Wagner worked with Bayerische Hypo- und Vereinsbank from 1987–9 and then read business administration from 1989 to 1994. From 1994–9 he was a research assistant and lecturer in the Department of Business Administration of the Catholic University of Eichstatt in Ingolstadt, where he also took his PhD on Business Ethics for Banks. Since 1999 he has been working for the Bayerische Landesbank, Munich, where he is a strategy specialist in the corporate development department. His main research interests are located in the fields of accounting and financial management of banks and in financial ethics.

Norbert Walter is Chief Economist of the Deutsche Bank Group and Managing Director of Deutsche Bank Research in Frankfurt/Main.

Justin Welby was born in 1956 and educated at Trinity College, Cambridge. He worked for eleven years in the oil industry, with Elf Aquitaine in France and then as Group Treasurer of Enterprise Oil, the third largest UK oil company. In 1989 he went to Durham University, reading theology, to train for ordination in the Church of England. He is presently Rector of Southam, in Warwickshire, England. He is also a non-executive director and Chair of the Audit Committee

of a local general hospital and Personal and Ethical Adviser to the UK Association of Corporate Treasurers.

Geoffrey E. Wood is currently Professor of Economics at City University London. He has also taught at the University of Warwick, and has been with the research staff of both the Bank of England and the Federal Reserve Bank of St Louis. He is the co-author or co-editor of ten books which deal with, among other subjects, finance of international trade, monetary policy and bank regulation. Among his professional papers are studies of exchange rate behaviour, interest rate determination, monetary unions, tariff policy and bank regulation. He has also acted as an adviser to the New Zealand Treasury. He is a managing trustee of the Institute of Economic Affairs and of the Wincott Foundation.

Bernd Zugenbühler is a Director of the Dresdner Bank AG in Frankfurt/Main.

This book is dedicated to
Hans Tietmeyer

Introduction

The index to a book is often a better key to a writer's or writers' purposes than the table of contents. A discerning reader or a reviewer looking for a controlling idea will find in the index to this book under the term 'ethics in banking' that there are twenty-four entries relating to matters of moral concerns in the world of money and finance; and there is a further search point in the index, perhaps a more unexpected one, 'companies as moral agents'. Most tantalizing of all, there is an entry for twelve pages on 'ethics of Economic and Monetary Union', written by a senior official from the UK Treasury. Maybe there is a modern struggle for the soul of the financial sector.

Over a period of eight years, the Von Hügel Institute, St. Edmund's College Cambridge, has been hosting regular seminars and occasional conferences on finance ethics. These have been organized on the principle that a credible morality of money is more likely to come from within the financial sector than from an isolated ethics constituency, whose growing literature on morals and money tends to be out of touch with the realities or is so jargonised as to turn off the hard-pressed banker, financiers or government departments. The approach in the seminars and conferences has been interdisciplinary, but more than they, the lead has been taken by the practitioners and economic theorists, whose thought patterns, concepts and language is scrutinized for an ethical agenda. The ethic is to be read out of the experience of the practitioners with informed ethicists acting as the midwife to the generation of a rigorous and vigorous finance ethic. This is not to downgrade the importance of ethics or to suggest a reduction of ethics to financial statements, but, rather, to articulate ethics in connection with the complexities and subtleties of modern markets and global operations. A model of the procedure can be found in Chapter 7 of this collection, which explores the role of ethics in derivatives markets.

The specific attention to ethics varies from one contribution to another. Some writers deal at length with financial structures, competition, risk management and accountability, paying little attention to formal ethical considerations. But the ethical dimension of ideas like risk, financial stability and banking supervision is at least identified and other contributors draw out the nature and place of ethics in the debate. Some chapters thus contribute to the challenge with which

ethicists must deal. British and German experiences are in the forefront of the issues under discussion.

In his keynote speech (Chapter 1) Norbert Walter points out that globalization means rapid expansion of world trade and foreign direct investment, but that it also means new opportunities for travel and unlimited exchange of information and knowledge. We have quantum leaps in data processing and telecommunication allowing us to produce more quickly and cheaply in a global configuration. He identifies 'the signs of the times' as competition, innovation and new strategies. Strangely enough, contemporary Catholic moral thinking has appropriated the term 'signs of the times' as central to the exercise of interpreting the ethical dilemma of modern life. The sharing of the term opens up important avenues for ethics in the banking sector explored by Norbert Walter. Mergers between banks, strategic acquisitions in new fields, specialization in niche markets and the whole process of rationalization cannot be removed from moral interpretation.

The perceptive comparison of the UK and German banking systems presented in Chapter 2 by Glenn Hoggarth, Alistair Milne and Geoffrey Wood not only highlights differences in banking performance but raises questions about the relationship of structures and the level and volatility of bank profits. In so far as systemic factors such as loose monetary policy and unsustainable increases in property prices are part of this analysis, ethicists must face them. Ethics is corporate as well as personal.

In Chapter 3 Jan Toporowski carries this discussion forward by looking at the issue of different institutions, conventions and histories causing problems in making systematic comparisons of financial systems in various countries. However, sectoral balance sheets can be made and compared to reveal institutional differences, economic changes and the fragility of financial structures. Its extensive foreign liabilities make the UK's financial system more fragile than that of Germany. This suggests that the European Monetary Union may be more stable without UK membership. But government debt gives assured liquidity to financial portfolios. The fiscal provisions of Maastricht therefore limit the security of the emerging European financial system.

Commenting on the Toporowski paper, Andrew Tylecote points out that the debt of trustworthy governments, arising from past deficits, helps stabilise financial systems, but present or expected future deficits are unhelpful. Currently in many countries the 'pension overhang' leads to expectations of future deficits. There is, in the world as a

whole, a shortage of sage would-be borrowers. How can this be allayed? According to Tylecote by

1. Government borrowing for high return investments with positive externalities – particularly primary and secondary education.
2. State backing for long-term borrowing by individuals for tertiary education. The ethical issue of poor countries and poor people being helped to become 'good risks' is an important question of finance ethics.

In the 1992 Von Hgel Lecture at the University of Cambridge Hans Tietmeyer, the former President of the Deutsche Bundesbank, raised the whole matter of monetary stability as an ethical issue in central banking.¹ In this spirit Forrest Capie and Geoffrey Wood explore in Chapter 4 of this collection the crucial question of the relationship of stability to industry in the comparative conditions of British and German banking. Different forms of behaviour in banking crises are identified as important and the weakness of lender-of-last-resort activity in the German system is viewed as a defect. A moral response to mitigate the effects of crises on citizens would need to look to structural adjustments as the beginning of appropriate policy.

Jan Kregel analyses the role of trust banks in Chapter 5. Starting with a discussion of the central issues of self-interest in market competition and the need for trust and confidence in financial markets, he gives an interesting historical account of legislation governing trust deeds and the development of trust banks in, for example, the UK, USA, Germany and Italy with their different types of regulation to produce trust relationships. In view of the trust banks' contribution to financial stability, the author quite rightly regrets the trend for trust banks being transformed into equity owned profit-maximizing banks and stresses the positive benefits being derived from a symbiotic coexistence of trust-based and profit-based banking organizations.

Chapter 6 by Barry Howcroft examines the traditional function of commercial banks as financial intermediaries between deficit and surplus sectors. Fundamental to this function has been the assumption

¹ Tietmeyer, Hans (1993) 'The Value of Monetary Stability in the World Today', in P. Arestis (ed.) *Money and Banking: Issues for the Twenty-First Century. Essays in Honour of Stephen F. Frowen*. Foreword by Helmut Schlesinger (London: Macmillan; New York: St Martin's Press), pp. 25–40.

that banks can intermediate at lower costs than those prevailing with direct financing arrangements, but developments in corporate wholesale financing over the past twenty years or so have significantly undermined this 'cost imperative' for large national and international companies. This has resulted in significant disintermediation of commercial banks by large companies and introduced a large degree of product innovation in wholesale corporate finance. These innovations have meant that commercial banks have become more investment bank oriented. Traditional on-balance sheet services for large companies have, therefore, been largely replaced by the off-balance sheet activities of providing investment advice, making replacements, the provision of standby facilities, etc. These fundamental changes in business activity have had a marked effect on the commercial banks' principal sources of income and the risks inherent in their business. Just as important, however, is the fact that innovations in corporate wholesale banking have far-reaching implications which go well beyond the corporate wholesale market and have fundamentally changed the commercial banks' 'business philosophy' and methods of management.

In Chapter 7 Justin Welby seeks to defend the use and development of derivative financial products, albeit with some caution. It concentrates on the concept of risk management, as a necessary duty of business managers. Derivatives are seen not as means of avoiding but rather as means of managing and allocating risk. If used to do this properly they are of great potential benefit. The paper looks at the ethical issues raised from a consequentialist, a rule-based and a virtue-based approach, finding the last to be the most useful in moving towards an ethical basis in finance.

Chapter 8 by Andreas Wagner draws attention to the fact that the banking industry is facing broad public unease because of a wide range of scandals such as insider trading, money laundering or misuse of funds. In this climate ethical questions have become more relevant for banks, especially because there is awareness that only the tip of the iceberg has been exposed. Regarding these developments, banks seem to need some good advice on how to cope with their ethical problems, in order to regain public acceptance and reputation. One main argument in this chapter is that the increase of disastrous incidents in banking is no evidence for the decay of morals in banking. It is much more likely that the structural incentives are wrongly placed in the sense that immoral behaviour pays out and moral considerations are being punished. The installation of an ethics management therefore seems to be gaining in significance.

Chapter 9 by Stephen F. Frowen and Elias Karakitsos presents an extended challenge to ethical thinking on the subject of savings-ratio behaviour in globalised money and capital markets. In a chapter that has independent value in finance theory, the need for ethicists to deal with complex realities is raised, even if no detailed ethical solutions are proposed. The question of short-term Keynesian stability policy and 'convinced' monetarist policy, with their different influences on inflation and on the behaviour of different classes of citizens is clearly an important ethical issue which has been tackled by careful attention to the realities identified by the comparison of UK and German policies drawn by the two authors.

After briefly surveying and comparing the performance of monetary policy in the UK and Germany, the authors introduce a model analysing the adjustment of consumption in the business cycle, investigate the savings ratio in UK business cycles and the effects of financial deregulation and liberalisation on the UK and other economies. While in the traditional view, the savings ratio varies procyclically because households are involved in consumption smoothing, this chapter points to the empirical evidence in the 1980s and 1990s which shows that in some countries the savings ratio varies counter-cyclically. This chapter identifies that such behaviour can be explained by an adjustment of the savings ratio not only in response to fluctuations of current to permanent income but also because of deviations of wealth from its target level. These fluctuations in wealth are the product of financial deregulation, liberalisation and globalisation and are triggered by changes in monetary policy. The more leveraged an economy is the greater the volatility of wealth and hence the more apparent the counter-cyclical adjustment of the savings ratio. The behaviour of the highly leveraged Anglo-Saxon countries and the less leveraged Continental Europe is compared and the role of monetary policy is analysed.

Eric Owen Smith's Chapter 10 is in part a thoughtful response to Chapter 9 by Frowen and Karakitsos. He focuses on the phrase 'conduct and ethical underpinnings of monetary policy'. This is a model for finance ethics in the complex setting of modern money markets, facing head-on perceptions of right and wrong and the moral obligations of monetary policy-makers. His quotation from Paprotzki that 'money is a fascinating subject of study because it is so full of mystery and paradox' might stand as a rubric for finance ethics. The author draws out the ethical implications of Friedman and Keynesian paradigms and illustrates the importance of these ethical considera-

tions to the analysis presented by Frowen and Karakitsos. Thus, it can justly be claimed that Chapters 9 and 10 constitute a paradigm for finance ethics.

In Chapter 11 Norbert Klotten investigates the behaviour of leading central banks vis-à-vis increasingly complex financial markets in a globalised world. The Bundesbank incessantly strived for stable money guided by internal monetary targets. Volatile exchange markets, the spreading of financial tremors and international responsibilities are likewise only secondary elements of the European Central Bank's decision-making. And the Fed – driving force (in cooperation with the US-Treasury and the IMF) behind any major international monetary agreement – acts as an autonomous, on-home-affairs concentrating central bank. Even the Bank of Japan, showing more or less voluntary solidarity with initiatives of both the IMF and the Fed, finally tries to serve national objectives. Paul Volcker, Chairman of the 'Bretton-Woods-Commission', stated in 1994 that Germany, the USA and Japan are not prepared 'to move toward a more formal system of exchange rate construction over time'. Time has not yet come for a Bretton Woods II. However, the Asian crisis, shedding a rather unfavourable light on both the Fed and the World Bank, has made obvious that internationally coordinated measures are imperative to consolidate the international financial system in order to safeguard a proper relationship between private commercial operations and an effective surveillance by national and international authorities, to agree on a reasonable set of sanctions in case regulations are disregarded, and finally to strengthen governance by the Fed. However, some of what needs to be done, is beginning to take shape.

As the United Kingdom has started to build its new Financial Services Authority, John Ellis explores in Chapter 12 some of the ethical dimensions of the key policy debates. The new Authority has responsibility for the whole financial sector. The globalisation of financial activity and the disappearance of old boundaries between different types of financial institutions present new challenges to regulators. They need to reassess whom it is they are seeking to protect, where responsibility lies for decisions in international institutions and what penalties are appropriate. The relationship of ethics and regulation is the underlying theme. Ethics stimulates regulation and continues the moral debate beyond the limits of what regulation can achieve.

Chapter 13 by Martin Donnelly presents a clear case of the finance practitioner as an ethicist by debating the question of whether Economic and Monetary Union is an ethical issue. In setting the ques-

tion, initially, in terms of winners and losers the writer immerses himself in the debate about the relationship of facts and values in ethics. The analysis is sustained throughout by the definition of *economic* union, compulsion, freedom, sovereignty and the operation of these through exchange rates and international financial structures. The thorny question of ethics and the art of the possible runs through every paragraph of this chapter.

In Chapter 14 Stephan Herten and Jens Hölscher analyse arguments in favour of either a credit-based or capital-based financial system for transition economies. The first part describes corporate governance theory and empirical research relating to financial development. On this basis they then describe some macroeconomic features of both systems and look for elements for a development strategy. This is contrasted in the subsequent sections with real-world attempts of transition economies. Finally, they argue that the way of solving the bad debt problem and hence the restructuring of the banking sector influences the type of financial system, which ultimately emerges. They come out in favour of a strategy of semi-liberalisation.

Chapter 15 by Udo Reifner and Juliane Pfau covers the need for and availability of social banking and affordable housing in Germany as an example of an inclusive bank product. The authors develop and evaluate ideas on how banks could be helpful in upgrading the social situation in metropolitan areas without relinquishing profits. They see a decisive role for banks to play in this field and conclude that the 'bank's name is needed for trust and reputation, its credit facility is necessary to give adequate and cash-flow-adjusted credit to the residents at affordable rates, its knowledge in marketing financial products could help to raise own-capital, and its tax advisers and lawyers may settle the necessary disputes with the internal revenue services'. Of course, there are fundamental differences in the way housing markets are financed in Germany and the UK, but some lessons could possibly be learned in the UK from the German experience and vice versa.

In the final Chapter 16 Leo Schuster deals with the role of compliance in Germany's banking culture. Every period of time has its favourite topics and even fashionable catchwords, the propagandists of which are primarily the media. This is also true for business, one of whose latest terms in banking is 'compliance', which in Germany is connected especially with insider trading. Compliance clearly has to have a double function: it should be, at once, a protection of customers' interests (namely shareholders, investors and issuers) and of employee and manager positions.

This book does not provide – and is not meant to provide – a theory of finance ethics. It allows its authors, looking mainly at German and British experiences, to set out parameters for the debate, guidelines for ethical considerations (both of a corporate and personal nature) and some finance-based examples to ethicists intent on developing finance ethics.

STEPHEN F. FROWEN
FRANCIS P. MCHUGH

Acknowledgements

I should like to acknowledge particularly the generous financial help provided by the Fritz Thyssen Stiftung, Cologne, which enabled us at the Von Hügel Institute, St Edmund's College, University of Cambridge, to organise the conference on which the papers contained in the present volume are based. I am also most appreciative of the ready response of the Anglo-German Foundation for the Study of Industrial Society, London, to collaborate with us and support us in every possible way. Its support contributed greatly to an occasion, which was intellectually as well as socially memorable.

My warmest personal gratitude is offered also to Tim Farmiloe, the now retired publishing director of Macmillan who originally accepted these conference proceedings for publication and who has for many years rendered me such inestimable help in a relationship which has developed into a much treasured friendship.

I further wish to record the great debt I owe to Keith Povey for the endless patience and care he has lavished on yet one more manuscript of mine, in copy-editing and supervision of detail, in a manner quite beyond praise.

Frank McHugh, my co-editor and much esteemed colleague, and I also wish to take this opportunity of expressing the feelings of appreciation and gratitude to Brian Heap, Master of St Edmund's College, for his incomparably kind support and encouragement.

This book is dedicated to Hans Tietmeyer, the former President of the Deutsche Bundesbank, who, amongst the leaders of the financial world, has been in the forefront of setting new and essential ethical standards.