FINANCIAL SERVICES INDUSTRY STUDY REPORT 1996

Participants:
CAPT Alan Harms, USN
COL Glen Lause, USA
Ms. Sue Baker, Dept. of the Army
Mr. Arnold Ellem, Australian Dept. of Defence
CAPT Ron Keys, USN
CDR Charles Webber, USN
Mr. Jim Russell, Defense Logistics Agency
Lt Col Tony Phillips, USAF
Mr. Steve Lyons, Office of the Secretary of Defense
CDR Larry Salter, USN
LTC Jim Rabon, USA
Lt Col Ken Stoehrmann, USAFR
Lt Col Mike Basla, USAF
LTC Joseph Frankie III, USA
Lt Col D. C. Pipp, USAF
COL Albert Yatkauskas, USA

Mr. George Fidas, faculty
Dr. Robert Pirog, faculty
Mr. Charles Pearcy, faculty

Places Visited (U.S.):
Securities and Exchange Commission, Washington, DC
Office of the U.S. Trade Representative, Washington, DC
Board of Governors of the Federal Reserve System, Washington, DC
National Association of Securities Dealers, Washington, DC
World Bank, Washington, DC
Export-Import Bank, Washington, DC
T. Rowe Price, Baltimore, MD
Alex Brown,
Federal Reserve Bank of Richmond, VA
U.S. Secret Service, Washington, DC
American Bankers Association,
Chicago Mercantile Exchange, IL
Chicago Board of Trade, IL
Chicago Board Options Exchange, IL
New York Stock Exchange, NY
Wall Street Journal, New York, NY
Goldman Sachs, New York, NY
Federal Reserve Bank of New York, NY
New York Mercantile Exchange, NY
New York Clearing House of International Payments, NY

Morgan Stanley, New York, NY
Paine Webber, New York, NY
Bankers Trust, New York, NY
Chemical Bank, New York, NY

Places Visited(International):
Citibank, London, UK
Bankers Trust, London, UK
European Bank for Reconstruction and Development, London, UK
U.S. Embassy, London, UK
Bank of England, London, UK
Merrill Lynch Europe Ltd., London, UK
Financial Times, London, UK
Bank of France, Paris, France
Financial Attache, U.S. Embassy, Paris, France
Organization for Economic Cooperation and Development, Paris, France
U.S. Mission to the European Union, Brussels, Belgium
Deutsche Bundesbank, Frankfurt, Germany
Frankfurt Borse, Frankfurt, Germany
Deutsche Bank, Frankfurt, Germany
European Monetary Institute, Frankfurt, Germany

ABSTRACT

As nations manifest their international power via economic rather than military assets, a nation's ability to raise and distribute capital and to assess, market, and spread risk becomes more important. These capabilities are fundamental to all economic activity, and a nation's achievements in these areas significantly affect its productivity and economic performance. Accordingly, it is important to objectively assess the threats, opportunities, and international competitiveness of the world's financial services sector in order to determine its relative importance to the U.S. industrial base and national security.

INTRODUCTION

Today, a nation's ability to compete in the international arena is inexorably linked to its ability to manage its finances. As the economic aspect of national power increases in importance, no nation can be truly secure if it cannot compete economically. And to compete economically, a nation must project an image of financial stability and be able to take an active role in world financial markets. The adage Amoney makes the world go round" has never been more true than it is today, but today money is being used more and more as a key aspect of national security strategies. How a nation, particularly the United States, manages its finances and becomes a successful player on the world financial scene is the subject of this report.

Today's financial environment features high interdependence and a global nature. Various nations, financial institutions, and in some cases national and international regulatory bodies make the system work. This report focuses on key elements of U.S. financial services, their interactions, emerging trends and issues that will affect the industry in the years ahead, and links between financial services and U.S. national security.

For the study, members of the financial services seminar read widely on financial services and discussed relevant issues during a series of seminars, each targeted at a different aspect of financial services. We researched domestic laws pertaining to financial services, trends in the United States's ability to manage its finances (for example, U.S. monetary policy), and the role of key institutions in the global financial environment, and prepared research papers, the key findings of which are contained in this report. Finally, seminar members visited a variety of organizations in the United States and Europe that participate in and help shape the world financial system, such as stock exchanges, central banks, large U.S. investment and commercial banking institutions, financial news services, regulatory agencies, advocacy groups, "hometown" banks, and savings and loan (S&L) institutions.

THE FINANCE INDUSTRY DEFINED

Financial services are provided by myriad institutions that continue to expand as the sector continues to diversify. Domestically, three key industry groupings, banking, securities (also referred to as investment banking), and insurance, each contain a variety of institutions.

Banking

The major institutions in this group are commercial banks and S&L associations. *Commercial banks*, the institutions that most people deal with every day control the payments system by clearing checks and drafts and providing other basic financial services. *S&L institutions* are similar in terms of service but tend to have a much smaller geographic focus and rely more on personal contact and their stature within a community to generate business.

Securities (Investment Banking)

This sector is made up of the world's investment banks and brokerage houses, the vast majority of which are located in the United States. Key activities include securities underwriting (raising capital through the creation and sale of new securities, both equity [stocks] and debt [bonds]), secondary market activities (executing securities transactions for retail and institutional clients such as pension funds), proprietary trading (trading securities for the bank's own account), mergers and acquisitions (e.g., participation in leveraged buy-outs.), asset management for wealthy clients, and analytical services.

Insurance

This sector contains companies generally associated with selling various types of insurance. But insurance companies no longer occupy the neat, well-defined niche in the financial services sector characterized by agents plying an assortment of whole, term, and health policies. Increasingly, savvy investors have unbundled their life insurance, opting to purchase relatively low-cost term policies and investing the difference in other, higher-yielding (and often riskier) financial instruments such as stocks and mutual funds. In response, the insurance industry has begun to offer new, more innovative products such as universal life policies and has ventured into the business of marketing derivatives--futures and options--to hedge risk. These products offer a new source of capital and give insurers the prospect of expanding coverage to currently uninsurable risks.

Internationally, insurers are moving more towards the reinsurance business--in effect, insuring the insurers--in order to minimize risk. This tactic prevents any one insurer from having to carry an unacceptable level of risk, which allows companies to insure additional clients. The move to reinsurance also allows more entrants into the industry in general, and, it is hoped, will lead to more competitive prices.

Regulatory Bodies

Domestically, much of the current regulation of financial services has its origins in the period following the Depression more than 60 years ago. At that time the U.S. government placed distinct limits on financial institutions by segmenting financial markets into the three industry groupings described above.

In addition to four federal agencies, 50 state banking commissioners supervise all state-chartered commercial banks, savings banks, and thrifts. National banks are supervised by the Comptroller of the Currency. The Board of Governors of the Federal Reserve System regulates its members, state-chartered banks, and all bank holding companies. The Office of Thrift Supervision regulates federal and state-chartered thrifts. The Federal Deposit Insurance Corporation regulates state banks not in the Federal Reserve System and assists in regulating national banks and state-chartered member banks.

Securities underwriting and sales are regulated by the Securities and Exchange Commission (SEC), an independent, nonpartisan, quasi-judicial agency. Using legal sanctions where necessary, the five-member commission (appointments are subject to Senate confirmation) administers federal laws seeking to ensure that securities markets are fair and honest. SEC staff administer laws written to ensure the disclosure of significant information required for informed investment decisions by the public. The SEC does not guarantee that investment offerings are of value or will be profitable, just that the information essential to making an informed investment decision is properly disclosed. The actions of securities brokers and dealers, publicly held entities, investment companies and advisors, and other participants in the securities market are subject to SEC supervision. In this regard the SEC reviews the performance of self-regulating organizations that run national securities exchanges. Individual U.S. states also regulate securities trading and insurance underwriting and sales within state borders.

International Organizations

The International Monetary Fund (IMF) was born out of the idea that nations working together to increase economic welfare could enhance the likelihood of political peace. The IMF's regulatory function was originally to keep exchange rates stable, ensure orderly exchange arrangements, avoid competitive exchange depreciation, and ensure a liberal regime of international payments through the convertibility of currencies and freedom from exchange restrictions (De Vries, 1986, 15-16). Over time and with the breakdown of the system of set exchange rates and convertibility of dollars into gold, the IMF has changed from a regulator into a lender.

The IMF's partner organization, the World Bank, has two tasks: reconstruction and development loans. These are funded primarily from the world's capital markets (unlike the IMF's member-capital-funded operations). The Bank is therefore also interested in a country's creditworthiness based on both external factors and the country's economic policies (Polak, 1994, 1-5). The merging roles have drawn some criticism, but the IMF maintains a relatively short-term focus while continuing to expand its dealings with developing nations and microeconomic issues.

Other, regional organizations support reconstruction and development in specific geographic areas. For example, the European Bank for Reconstruction and Development targets former command economies trying to make the transition to a market-based system. Similar organizations exist for Africa, Asia, and South America.

CURRENT CONDITIONS

As it moves into the 21st century, the financial services industry is being rapidly transformed by advances in communications and computer technology, resulting in an increasingly competitive and dispersed marketplace, and by new products. "The traditional financial market products--bank credits and 'plain vanilla' debt and equity underwritings--have been overshadowed by financial instruments of greater complexity . . . derivatives, options, index products, asset-backed securities and myriad other innovations" (Hayes, 1993, xi).

A healthy market has a mechanism that enables the financial system to share and pass information about bonds, stocks, and other investment instruments to a society's savers and investors in order to assist them in portfolio allocation decisions. Securities market institutions such as investment banks, stock exchanges, and brokers fulfill this role in the United States. They enable financial markets to operate smoothly, thereby facilitating domestic and international investment in key product and service sectors. Blanden (1995, 22) has noted that "there is no doubt that securities underwriting will in general terms be opened up to the banking industry; while securities will be able to adopt banking status . . . . Still to come [is] letting banks into the insurance industry and allowing non-financial companies to invest in or own banks."

Proposed legislation involving the finance industry revolves around attempts to repeal the Glass-Steagall Act or to allow more freedom of movement in the industry. The struggle among the interest groups (i.e., commercial banks, investment banks, insurance companies, local savings banks, consumer groups, industry associations) will not be resolved soon. The continuing, de facto movement toward increased deregulation was highlighted by the April 1996 Supreme Court decision to allow banks to sell some types of insurance in certain markets and to allow commercial bank-owned companies and commercial bank personnel to sell securities, annuities, and stock mutual funds.

The legislative changes affecting the finance industry are balanced against certain industry requirements generated both internally and externally. Internally, all financial institutions strive for a healthy level of profitability, assisted today by the relatively more conservative nature of the industry (brought about in response to such recent "shocks" as S&L bailouts and the derivatives "scare") and the enormous profits generated by the credit card business (not found in some non-U.S. banks). Externally, these institutions have to deal with customer concerns regarding security and privacy for those wishing to use computer banking and on-line stock trading services--a pressure that will surely continue to grow.

Internationally, these same institutions must be prepared to compete on a global scale as trade barriers fall and competitiveness increases. While U.S. financial institutions are still the clear leaders in the financial services industry, their leadership is under pressure as foreign financial institutions, many with the help of user-friendly national laws, expand their international presence.

CHALLENGES

Five key challenges facing the financial services industry are the rise of mutual funds, the U.S. saving rate and public sector deficit, the increasing complexity of financial instruments, the use of new technology, and the increased use of quick international transfers.

The Rise of Mutual Funds

Americans have increasingly sought to make their own decisions about risk and return. Moreover, they want convenient services and technology and information that will allow them to achieve their financial goals (Szabo, 1994, 22-24). These desires have underpinned part of the seismic shift to the mutual funds market. In 1980, investors could choose from among 564 funds. Today, 10 times as many funds embrace different investment styles and asset categories. In the past 10 years the value of the mutual fund industry has grown from about $500 billion to $2.6 trillion ("Wall Street," 1996, 6). Tired of low interest rates at banks, average workers are looking for higher returns on their investments. Unfortunately, most workers, despite great confidence in their investment capabilities, lack the most rudimentary knowledge about the way their 401(k) pension fund works or the risks of the investment vehicles they are using. Even individuals who believe they are seasoned investors really do not understand funds and basic investing principles (Updegrave, 1996, 98).

With workers putting all their eggs in the mutual fund basket, the big questions become, what will happen if the stock market does not continue to climb? Should a business that has no insurance safety net other than public confidence have more stringent controls? Are investment funds managers managing funds for their own gain or for the fund's shareholders? What is the role of proprietary trading?

And what about market influence? Currently the Fidelity fund family controls about $550 billion of stock. On any given day, Fidelity accounts for 10-15 percent of the volume on the New York Stock Exchange. The sheer size of Fidelity, whose multiple families of funds buy and sell the same stock, can place incredible pressure on the market. At the end of September 1995, for example, Fidelity owned 12.22 million shares of Motorola. During October and November it sold approximately 8 million shares, driving that stock down 18 percent (Fromson, 1996, A1, A18). Substituting a critical defense company or a foreign-controlled investment fund for Motorola leads to intriguing implications for possible damage to the industrial base.

The U.S. Saving Rate and the Public Sector Deficit

> *In 1900 only one in twenty-five Americans was over sixty-five. The vast majority of these people were completely self-supporting or supported by their families. By 2040 one out of every four or five Americans will be over sixty-five, and the vast majority will be supported to some degree by government entitlements.*
>
> (Peterson, 1996, 57)

In 1993 Americans saved only 5.4 percent of disposable income, and in 1996 private saving is around 5 percent after taxes. In contrast, private saving in Germany, Japan and South Korea is in the range of 12-30 percent. The situation is considered so grave that last year the Labor Department spent $2 million on a campaign urging Americans to save more.

Personal saving rates have decreased over the last four decades. The 1950s saw a rate of 6.8 percent, the 1960s of 6.7 percent, the 1970s of 8 percent, the 1980s of 5.4 percent, and the early 1990s of 4-5 percent. To explain the decline in personal saving, some claim that the rate does not account for all the ways Americans save. Since a nation's total rate of saving equals private saving plus government saving, Americans could be saving more than the numbers indicate. A 1989 Federal Reserve Board study that used a broader gauge of what constitutes savings concluded that the real 1980s savings rate was closer to 12 percent. If involuntary saving--government "forced saving" such as personal and employer taxes paid to fund Social Security, Medicare, and Medicaid and employer contributions to health and pension plans--are taken into account, the rate is even higher.

Changes in the availability of credit have affected saving patterns. Credit cards and loans, once used for emergencies and convenience, have become a source of capital to fund a higher standard of living by making it easy for Americans to purchase items for immediate consumption. Baby boomers (who head 41 million U.S. households) allocate three times as much income to debt other than mortgage (23 percent) as to retirement savings (7 percent). Another 26 percent is allocated to mortgage debt.

The failure of Americans to save enough for their own needs will make it more difficult for them to retire, and the problem will compound for each succeeding generation. A growing retiree population, increasing longevity, rising health care costs, and a shrinking work force could have devastating consequences for the future of the United States. Currently there are 3.4 workers for each Social Security beneficiary. In 2035 the ratio could be as low as 1.9 to 1, which could have dramatic consequences for national cohesion, standards of living, tax rates, and the ability of future U.S. workers to save for their own needs.

The federal government drains off a large share of the already low pool of private savings available for domestic investment. In the past decade government spending and trade deficits have strangled domestic savings. The federal deficit consumed nearly 45 percent of the nation's available private savings in 1994. The larger the deficit grows, the less freedom of action the government will have to spur growth without fueling inflation and long-term interest rate increases. More important, a low saving rate coupled with twin deficits (i.e., trade and government) may affect long-term national security.

The United States has become a net importer of capital. Reliance on foreign capital places pressure on interest rates needed to attract investment and results in capital outflows to foreign debt holders in the form of interest payments. The higher the reliance on foreign savings, the more risk the United States takes in finding finance.

The Increasing Complexity of Financial Instruments

Increasingly complex financial instruments cover new areas. For example, derivatives are financial contracts whose value is tied to some other underlying asset, such as currency, an equity, another commodity, or an indicator like an interest rate or index--that is, their value is derived from some other tangible asset. A derivative, much like an insurance policy, is a financial instrument designed to separate some of the risks associated with an investment from the investment itself. Once isolated, the risk can then be transferred to someone willing to assume that risk (for a price).

Investors and fund managers routinely use derivative securities to hedge against investment risks, leverage their investment potential, or speculate on different types of securities. The most common types of derivative securities are futures and options, which are contracts to buy or sell shares of stock (or a commodity) at a specified price on a specified date. While companies can buy and sell futures and options as part of their financial portfolios, they are more likely to use derivative contracts with major investors, banks, or insurance companies to transfer some of the risks of their projects (and rewards) in order to craft a more predictable profit margin.

These types of arrangements are usually *not* publicly traded securities on the major financial exchanges. They are usually not very liquid. A key point is that they are not necessarily derivative securities--just derivative agreements. Therefore most of these transactions are not subject to the scrutiny of the SEC or any of the major market self-regulatory bodies. But the problems with derivatives seem to stem from a failure on the part of investors to fully understand the risks involved. This failure may be due not to the increasingly complex nature of these investments but rather to the failure to ask tough questions about risk, value, exposure, and accounting practices.

Clearly some regulation is needed to require publicly held companies, mutual funds, and municipal governments to disclose to their shareholders the inherent risks of the derivatives held. Full disclosure will allow investors to decide for themselves whether or not a particular company or fund has an acceptable level of risk. Investors with a high tolerance for risk may seek out highly leveraged companies and funds. But investors with a low tolerance for risk should not be misled into funds that appear safe but are actually quite speculative.

While derivatives have gotten a bad name, when used prudently they are an effective way for companies, funds, and money managers to reduce risks. They offer companies the chance to isolate risks associated with future cash flows, interest rates, and other variables and ensure steady profit margins.

Use of New Technology

The transition to electronic commerce in the domestic retail sector is occurring in three phases. The technology for each phase is in use, and consumer acceptance builds on the success of earlier phases.

Phase One. Automatic teller machines (ATMs) and telephones have made remote distribution possible and are well established.

. 40 percent of U.S. mutual funds are distributed via phone and mail.

. 57 percent of U.S. banking transactions take place outside the branch (24 percent by phone and 31 percent by ATM).

. Nearly 20 percent of consumers visit their bank branch less than once a month.

Phase Two. The use of the personal computer (PC) combined with information reporting through on-line network services is growing rapidly, although the full impact, which will be profound, at least for technoliterate users, is several years off. Over 30 million U.S. households, including more than 60 percent of the top income quintile, own PCs, and more than 20 percent of PC owners manage their financial affairs on their PC. While widespread acceptance of phase two is some years away, attractive segments of affluent customers are progressing much more rapidly. Financial institutions are taking action to position themselves for the next phase of the industry's evolution.

Phase Three. Electronic cash (E-cash) and interactive video--digital money-- are the ultimate money exchange medium for an increasingly wired world. E-cash will evolve in two areas: (1) the continued development of secure ways to use on-line transfers and (2) the development and acceptance of an "electronic wallet" that will allow convenient transport of small amounts of cash for typical purchases. Combining purchase convenience with information will have significant effects on financial services and other industries.

The widespread use of E-cash will make geographic presence obsolete. Customers will not need to visit local branches to make deposits and withdrawals. ATMs will not need to be stocked with cash. Instead, consumers will be able to obtain E-cash in their own homes via phone, PC, or dedicated terminal. Before E-cash becomes a widespread medium for money, however, significant conceptual problems must be solved:

. Bank and governmental control of the growth of E-cash systems.

. The digital security of E-cash versus the physical presence of notes and coins.

. The possibility that E-cash will widen the split in U.S. society between the haves and have-nots. Only those who can afford the technology would have easy access to it.

- Threats from computer hackers, information warriors, counterfeiters, money launderers, and tax evaders.

Current interactive video technology is cumbersome and costly, but future developments will make the technology more user friendly and cost effective--allowing a full suite of financial services on interactive video to be extended to the office or home.

The use of new technology in commodities and stock markets is unlikely to soon replace human involvement in floor trading operations. The exchanges are still protective of their "open auction" price discovery methodology and cite the necessity to see another human being when making a trade. New technology (e.g., new flat-panel screens on trading floors and automated systems for trading outside normal hours) will be used to assist rather than supplant traditional methods until exchange owners are confident that new technology can provide more effective, cheaper, and faster operations.

Quick International Transfers: "Hot Capital"

The increasing propensity of capital to move freely in search of high returns and security presents different challenges for investors, businesses, and governments. International capital transactions and foreign exchange fluctuations affect every nation that plays in the global economy. Markets assess a nation's economic policy or a business's performance and react quickly. Investors need to be constantly aware of this information and its effect on the risk or return of their investment. Businesses and governments may find that market assessments change the availability of capital (i.e., a flight of hot capital that moves in search of relatively better opportunities), exchange rates, or the cost of financing debt.

OUTLOOK

Domestic

Investors have increasingly been *transferring money from bank accounts to other investment vehicles* such as money market and stock mutual funds. Over the last 20 years, the share of financial assets managed by banks declined from nearly 40 percent to about 24 percent (Baris, 1994). Between 1983 and 1994, commercial banks' share of total net lending fell 25.2 percent, while their share of total credit market assets fell 20 percent (Reinbach, 1995, 47).

The *number of banks in the United States declined* from a peak of nearly 30,000 in 1920 to under 10,000 in the 1990s, with the top 100 holding 80 percent of asset value. The number of consolidated "megabanks" with a national presence has increased.

Investment banks are facing increased competition from their customers. Many large companies are hiring their own internal financial expertise, which enables them to develop contacts and in-house aptitude that have traditionally been the purview of the investment banker. Increasingly, in merger and acquisition transactions, "more and more companies are shunning Wall Street and are negotiating and completing mergers with little, if any, help from bankers" (Raghavan and Lipin, 1996, A1).

There is *a move from personal to electronic services*. Banking (and financial services in general) in the past was heavily based on individual attention and personal relationships. Electronic investment and banking does not lend itself to such personalized service. Some customers are not willing to do things differently and, when forced, many are finding it difficult to change. Retail banking may become a very disaggregated market serviced by some giant national institutions but retaining opportunities for niche neighborhood or regionally based institutions.

In the next decade *banks aim to become the "one-stop shop" for all financial products* from loans to insurance. Six years ago banks were not in the business of selling mutual funds. However, in 1995 banks sold over 20 percent of the mutual funds sold in United States. If this trend continues, the line between commercial and investment banking will disappear. Some financial institutions have already started working around the Glass-Steagall Act.

International

An increasing number of large, non-U.S. financial institutions--particularly commercial and investment banks--are developing strategies to compete in the global financial services market. This trend is severely testing the traditional preeminence of U.S. institutions in this market and is contributing to increased competition among large financial services companies for a share of the world market. Since regulations governing financial services differ in each nation, these companies establish strong footholds in the more liberal nations and use them as a springboard for pursuing other opportunities worldwide.

A second identifiable trend is the *opening of previously closed financial markets to more competition* as a result of the World Trade Organization (WTO) agreement on financial services concluded in 1995. While this landmark agreement does not level the financial playing field entirely, it does offer incentives for financial services companies to compete in the international marketplace.

Third, the increased competitiveness in the financial services sector and the increased use of technology to conduct financial transactions has resulted in virtually *24-hour, worldwide trading in almost all financial instruments*. Today, a stock market is always open somewhere in the world, and financial services firms can trade at any time for their customers on one or more of these markets. Institutions often play these markets against each other, hedging their risk on one market while making investments on another. In addition, the rise of these markets has provided additional outlets for raising capital, thereby allowing companies and, in some instances, nations to participate to a greater extent in the world's marketplace.

Finally, much of the world financial community is engrossed in *Europe's efforts to establish a single currency* before the turn of the century. The conversion to a single currency will not be easy, especially given that the "loss" of one's own currency is an emotionally charged issue that transcends both the political and economic advantages of going to a single currency. The cost to financial institutions will be high--some estimates range upwards of $2 billion--but, in general, these institutions favor such a move as it will in the long run reduce costs and add stability to the European financial markets. Many hope then to see the new "Euro" successfully competing against the U.S. dollar as the world currency.

GOVERNMENT GOALS AND ROLE

> *Many analysts hold that excessive public interference will drive down returns on early-stage investments below levels necessary to attract venture capitalists and hence argue that governments should limit their role to assist in setting up the market infrastructure and in creating an environment that is conducive to entrepreneurships.* (Organization for Economic Cooperation and Development [OECD], 1996, 17)

While this statement specifically addresses the role of the government in the venture capital arena, it can be argued that the same approach should be followed for the entire financial services industry. A central bank now has less power than before in directing economies and needs to keep constant watch over other central banks and the worldwide financial markets. The markets assess economic policy and performance and declare results (in the form of foreign exchange and interest rates) with increasing speed. Because the volume of a single day's foreign exchange trading dwarfs the currency reserves of any nation, central banks can only work with and influence, not directly control, market sentiment. As worldwide deregulation continues, cross-border transactions and capital transfers multiply, and new markets emerge, the influence of the market over central banking institutions seems set to continue increasing. One reaction to this trend has been the formation or revitalization of multilateral forums and institutions (e.g., the OECD, the WTO, the IMF), to maintain central bank and governmental influence.

Where the government can continue to play a role is in ensuring that the nation is a stable place to invest. This includes taking action, when necessary, to keep the nation's currency stable in relation to other, possibly stronger, currencies on the world market, developing a regulatory climate that does not stifle capital formulation, and adhering to sound fiscal principles (such as a balanced budget and encouragement of private and public sector saving) that inspire confidence in the country and its economy. In the long run, the government's role should be one of nurturing a broad-based financial framework that helps promote stability and economic well-being.

Public authorities are increasingly aware that fostering venture capital activity is critical to gaining the economic and social benefits discussed earlier. (OECD, 1996, 33)

The government must also continue to encourage increased market access to the broad spectrum of financial services. A great deal of progress has been made in this area, culminating with the signing of the financial services agreement under the 1995 General Agreement on Tariffs and Trade (GATT) negotiations. While the GATT has opened up some additional financial activities to competition, additional steps must be taken to further relax government restrictions on access to financial markets. For example, a worldwide agreement on general accounting principles will help level the playing field and allow any aspiring financial services company or new business desiring to raise capital to compete in the constantly expanding free-world capital markets.

On the international scene, many governments actively encourage their respective financial institutions to participate in the international marketplacc through lax (relative to the those in the United States) laws and regulations that clearly favor the development of large, single-source financial institutions. For example, it is no surprise that London, with its "user-friendly" banking laws and history of self- (as opposed to government) regulation, has become the center of financial services for Europe. Likewise, the special relationship between German commercial banks and German industry (a bank often owns upwards of 25 percent of a company it finances) means that the banks have a relatively risk-free investment in Germany, freeing them to expand internationally.

In the final analysis, the goal of foreign governments is to encourage their financial services institutions and create an economic cnvironment that fosters their ability to compete in the international marketplace. While other institutions (particularly U.S. ones) can also take advantage of these environments by establishing operations in other countries, it is clear that many nations sec the role of the government in the financial services sector as one of actively supporting domestic financial institutions.

CONCLUSIONS

Our assessment of U.S. comparative advantages and disadvantages in financial services follows.

The United States's comparative advantages in financial services are its ability to raise and distribute capital (particularly venture capital); to assess, market, and spread risk (through commodities exchanges, new financial instruments, and experience in commercial risk assessment); and the growth of mutual and pension funds. The latter are a macroeconomic advantage if they add to overall savings levels and provide a vehicle for U.S. penetration into overseas equity and finance markets but a microeconomic disadvantage if the individual investor is not aware of the risks involved. *The United States's comparative disadvantages* in financial services are the low saving rate and the vulnerability of its information system, such as single-point (e.g., clearinghouse) operations as well as broader system characteristics. Our assessment showed the U.S. regulatory burden to be on balance neutral in comparison with that of other nations. That is, perceived domestic disadvantages in stricter regulation in disclosure and accounting standards are offset by the positive attitudes of overseas investors and general U.S. attitudes toward risk and business (e.g., U.S. versus Japanese handling of bad loans crises).

Based on our assessment, we make the following policy recommendations.

All levels of U.S. government should follow sound fiscal and monetary policy (including reducing the deficit, encouraging higher personal saving, and maintaining a favorable environment and infrastructure). The United States's low personal saving rate is reducing productivity and competitiveness by restricting the capital available for financing the construction of plants and the creation of jobs. In the next century higher living standards, national security, and U.S. economic preeminence will depend on productivity-boosting investments that start today. Sound public policy is crucial.

"It's time to face up to the fact that trust-fund accounting is a hoax, that Social Security is in fact a pay-as-you-go system. Payroll taxes go directly to today's beneficiaries; benefits come directly from today's workers" (Peterson, 1996, 61).

Tax breaks to encourage longer-term investment horizons, research and development, and the transforming of basic technology into market products are examples of strategies government could pursue.

The federal government should continue to champion central bank cooperation, multilateral development bank efforts, and global deregulation of financial services. Keeping central banks focused on common policies for economic growth and price stability helps to provide a favorable environment for trade and investment. Multilateral development banks assist U.S. foreign policy aims by encouraging the spread of market-based economies. Continued global deregulation will allow U.S. financial services into new markets and expand their share in existing markets.

In summary, the U.S. financial services industry is the world leader that sets the standard for others. U.S. accounting principles, standards for information disclosure, venture capital formation, and risk assessment methodologies are key to this current position. Continuing ingenuity and effort will be needed to keep the United States out in front.

BIBLIOGRAPHY

Baris, Jay G. 1994. "Congress vs. the Banking Industry: A Road to Disaster." *USA Today: The Magazine of the American Scene* (September).

Blanden, Michael. 1995. "The Walls Come Down.." *The Banker* 145, no. 832 (June).

De Vries, Margaret Garritsen. 1986. *The IMF in a Changing World.* Washington, DC: International Monetary Fund.

Fromson, Brett D. 1996. "Sizing Up Fidelity." *The Washington Post* (January 28).

Hayes, Samuel L., III. 1993. *Financial Services Perspectives and Challenges.* Cambridge, MA: Harvard Business School Press.

Organization for Economic Cooperation and Development. 1996. *Financial Market Trends: February 1996.* Paris.

Peterson, Peter. 1996. "Will America Grow Up Before It Grows Old?" *The Atlantic Monthly* (May).

Polak, Jacques. 1994. *The World Bank and the International Monetary Fund: A Changing Relationship.* Washington, DC: The Brookings Institution.

Raghavan, Anita, and Steven Lipin. 1996. "Going It Alone: More Companies Shun Investment Bankers, Do Their Own Deals." *The Wall Street Journal* (March 6).

Reinbach, Andrew. 1995. "History in the Making." *Bank Systems and Technology* 32, no. 6 (June).

Szabo, Joan C. 1994. "The Changing World of Financial Services." *Nation's Business* (October).