mess for the United States. I have never seen that case stated so clearly.

In his discussion of the implementation of the EEP in 1985, Bruce Gardner argues that besides the fact that the European Community was subsidizing wheat exports to developing countries, the most compelling argument in favor of the U.S. export enhancement program was the fact that it was scored as budget neutral by the Office of Management and Budget (OMB). Yet, he goes on to argue persuasively that the program was never budget neutral. In his comments, Robert Paarlberg points out that the original program was the brainchild of David Stockman, who was the Director of OMB, and that Stockman’s role in initiating the program may help to explain the willingness of OMB to stand by its own incorrect assessment of the budget impact of the EEP.

David Orden’s chapter on the role of agricultural interest groups in the adoption of NAFTA is fascinating. He explains in detail the way that special interest groups influenced the structure and schedule for implementation of the provisions of the NAFTA agreement with respect to agricultural products in general and with respect to sugar, peanuts, fruits, winter vegetables, and wheat in particular. The story he tells reflects a reality that is unrelated to the public political debate about environmental safety, fairness in trade relations, and the risk of lost jobs in America that generated less than 50 percent public support for NAFTA when it narrowly passed in the House in November, 1993. One cannot read this material without wondering how the public debate got so disconnected from the petty wheeling and dealing that constituted most of the real action in Washington.

In his chapter on the lumber industry, Joseph Kalt indicates that his analysis suggests that traditional capture theory rather than the “new institutionalism” is a better reference for understanding the outcomes in countervailing duty cases in the U.S.-Canada lumber wars. If that result generalizes in further studies, it will seriously undercut the argument of many trade economists in the late 1980s that we can only make further gains in understanding protectionism by doing case studies because institutional contexts are critical in shaping outcomes.

This collection of industry studies is remarkable to me because the weight of the evidence provided here convinces me of two things I had not appreciated until now. First, the era of broad trade restrictions really is disappearing. Protectionist battles are likely to be fought on an industry by industry basis from now on. Second, the battle for trade liberalization is not over and it will have to be fought sector by sector. The need for industry studies exists, less because they will provide us with broad understandings of the dynamics of trade regulations, than because that is where the action is likely to be for the foreseeable future.

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G Financial Economics


At a time when the Japanese Banking System is being rescued from insolvency by what is effectively a government bailout, the objectives of this book—to analyze the Japanese Main Bank system and to examine its relevance for developing and transforming economies—may seem anachronistic. It is not. The first part of this collected volume documents how the system funneled funds from the public to a ruined postwar industrial sector, thereby generating high growth between the 1950s and the 1970s. The papers also describe the changes in the 1980s as the banks started facing competition from both domestic and foreign securities markets. The book offers a succinct analysis of why the system worked until quite recently. It also helps the reader judge whether the recent crisis is an aberration, or inherent in the system. I was less convinced, however, that the main bank system is relevant for developing and transforming economies.

The introductory chapter by Aoki, Patrick,
and Sheard, and Chapter 11 by Patrick, summarize the main insights. The core of the system is the relationship between the main bank and the firm. This includes the provision of various financial services such as credit, payment settlement, foreign exchange, and investment banking and advisory services, as well as other links such as reciprocal shareholdings, the dispatch of directors from the bank to the firm, and the implicit guarantee offered by the main bank to other creditors. But the relationships between the bank or the firm and other financiers, and between these actors and regulators are also important in understanding the system.

The main bank system emerged from the ruins of the Japanese economy after World War II, though as Teranishi points out, the wartime government practice of designating firm-financier ties, and directing credit towards key sectors, set important precedents. Furthermore, the breakup of the old zaibatsu (the prewar Japanese industrial groups) and the postwar attempt to “democratize” and disperse shareholding gave firm managers excessive control over their own destinies. Thus the main bank system arose to restore the balance and to provide investors some control over firm managers. Finally, an important catalyst was that the postwar government actively favored bank financing over market financing. Ueda discusses three important facets of this favoritism; First, subsidies were provided to banks through interest rate regulations, entry restrictions, and government guarantees. Second, the government directly funded banks. Third, corporate financing from other sources, especially from bond markets, was severely restricted. The consensus in the book is that this was the optimal way to jump-start the economy in an environment where both the corporate and banking sector were insolvent. The rents and guarantees provided to the banking sector recapitalized it, and made banks secure enough for depositors to return. Banks, being large financiers, could then channel funds effectively to the fragile corporate sector. Finally, restrictions on bond market financing forced firms to stay in long-term relationships, giving banks both the incentive to subsidize them in times of distress and the ability to recoup the subsidy in the long run.

Therefore, in an initial environment where no agents had sufficient reputational or monetary capital to be trusted with funds, the government stepped in to intermediate between savers and borrowers. But why did it have to be the banking system that was favored? Could recapitalizing the industrial sector and then allowing savers to put their money directly in firms have had similar effects? Hoshi, Kashyap, and Loveman suggest it was not because the main bank system is more effective with distressed borrowers: First, the main bank can coordinate rescue efforts along with other banks in better ways than if creditors were dispersed. Second, its past relationship gives it the information to start early intervention. Third, the banks interact with each other repeatedly across many transactions, and have an incentive to cooperate in workouts. Sheard provides extensive empirical evidence consistent with these advantages.

But what if firms are healthy? The main bank may still have value, because it monitors the firm on behalf of other creditors. This prevents costly, repetitive monitoring. Furthermore, it gets substantial information from various channels such as the payments the firm makes from the accounts it keeps with the bank. Because it is informed, can take prompt corrective action, and has reputational concerns, a main bank relationship subjects firms to investor control, thus enabling them to obtain finance at lower cost. Finally, as Aoki argues, the main bank obtains more bargaining power as a firm moves closer to distress. The contingent nature of this power is one of the important virtues of the system.

There are, however, questions the book hints at but does not answer fully. For instance, is continued financial repression (as opposed to the initial repression needed to recapitalize the banking system after the war), especially restrictions on direct market finance and interest rate controls, necessary for the success of the system? The answer is important because the recent collapse of disciplined lending was preceded by the liberalization of the system, suggesting a possible connection. Another question, given the cru-
cial role of the government, is how the bureaucrats in charge remained immune from corruption. Recent evidence suggests more corruption than hinted at in the book, but it is still small by the standards of other developing and transforming economies. One wonders then whether the earlier documented virtues of the system can be replicated in other countries. For instance, Bhatt argues the lead bank system in India was far less successful, even though the system was designed with similar intent. Why did it not work in India? Was it because of excessive government interference or less competent and more venal bureaucrats in India? If so, how should developing countries guard against this? Finally, the book, while documenting the value of banks when an economy has young and growing firms, also hints at the opposition banks pose to liberalization when firms become mature enough to tap the markets themselves. Will the transition to a more market based form of finance be delayed if banks are given too much power when an economy is young? If so, how should the resulting costs be weighed against the benefits of the system? While these questions all suggest more research before the Japanese system is advocated for other economies, the authors in this book have done a splendid job in educating the reader about it.

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After the Savings and Loans debacle and the solvency problems of banks in a host of countries the book by Dewatripont and Tirole comes to illuminate the thorny issues associated with the prudential regulation of financial institutions using an insightful and coherent analysis.

The authors argue that the main goal of regulation is the protection of small depositors and that the main tool to accomplish it is to bring about an efficient corporate governance structure for banks. According to Dewatripont and Tirole the distinguishing feature of banks is that their debt is held by small investors who are not able or willing to monitor banks’ activity. Hence, depositors need to be represented by a public or private agent. Aside from this, banking regulation must deal with essentially the same issues that arise in connection with the control of firms by large creditors.

The starting point of Dewatripont and Tirole is to consider a bank as a managerial firm. Then, they confront the challenge of explaining why the capital structure of banks, that is, their solvency or debt/equity ratio, matters from the point of view of a manager’s performance. Indeed, we know from the Modigliani-Miller theorem that if complete contracts between owners and managers could be written then financial structure would be irrelevant. To get around this the authors turn to the incomplete contract paradigm to build their model.

A key assumption is that external intervention, which is crucial to affect managerial incentives, is “noncontractible.” The view is that the incentives that can be offered to managers are limited by problems of verifying the bank’s performance. Dewatripont and Tirole’s basic model is extremely simple. They consider a manager whose unobservable effort affects the quality of the bank’s loan portfolio and whose only objective is to preserve the private rents (perks and so on) of staying in the job. Furthermore, the party who has control over the bank (be it shareholders or debtholders), can choose only between a risky “continue” and a conservative “stop” action (involving possibly a reorganization, cancellation of projects, . . . ). Efficiency then requires that there should be more interference with management when the (verifiable) performance of the bank is poor. The optimal managerial incentive scheme can be implemented in a variety of ways, including contingent control mechanisms, net worth adjustments, and a recapitalization scheme. The basic idea is always the same: When performance is good, control should stay with shareholders who have a tendency to be “passive”—that is, to continue with the risky course. This is so because shareholders have a convex return structure due to limited liabil-