# Book Review

**Comparing Financial Systems.** Franklin Allen and Douglas Gale. Cambridge, MA: MIT Press, 2000. 520 pp., $29.95, ISBN: 0-26251-125-8.

There is a large variety of financial systems in different countries. Even if one limits oneself to the developed economies of the world, there is considerable cross-sectional heterogeneity in financial systems. Moreover, financial systems are far from static. Like biological species, they tend to evolve. And as in the case of biological species, the evolution is relatively smooth except during times of crises and stress when more dramatic forms of metamorphosis are observed.

The Allen and Gale book on financial systems is an attempt to provide a coherent research perspective on the rich cross-sectional variety and intertemporal dynamics of financial systems. The term *financial system* is typically used to describe the collection of financial intermediaries—venture capitalists, investment banks, commercial banks, insurance companies, and so on—and stock, bond, and contingent claims (derivatives) markets that are collectively responsible for allocating resources and redistributing risks in the economy [see Thakor (1996) for an extensive discussion]. Allen and Gale actually expand on this seemingly comprehensive definition and argue that a theory of financial system design must also include a theory of the firm. That is, they make the provocative proposal that firms, rather than being viewed merely as beneficiaries of the financial system, ought to be thought of as an integral part of the financial system. This not only expands the boundaries of the research agenda on financial systems but also makes the task more challenging and exciting.

With this as the backdrop, it is useful to summarize the questions Allen and Gale pose and answer in this book:

1. Why does there not seem to be a dominant financial system? Why do we observe such a variety of financial systems, even among developed countries?
2. Why do some countries have more significant stock markets than others?
3. Is the competitive structure of the banking system important?
4. How should one integrate the theory of the firm with a theory of financial systems?
5. What are the risk-sharing properties of different financial systems in terms of the risks to which individual households are exposed?
6. How do different financial systems cope with financial crises?

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Allen and Gale focus on financial systems in five developed countries—the United States, the United Kingdom, France, Germany, and Japan—to gather numerous interesting stylized facts to motivate their analysis of these questions. They are careful to clarify at the outset that their book is *not* a comprehensive survey of financial system design or a synthesis of banking [I agree with the authors that Freixas and Rochet (1997) provide an excellent synthesis] or a treatment of the growing and influential literature on finance and economic development [e.g., see the recent Levine (1999) paper].

A short review like this can hardly do justice to the extensive discussions of the above questions that appear in the Allen and Gale book. But here is an overarching summary of their answers to these questions.

First, on the issue of why there is such a variety of financial systems, the authors argue that financial systems have evolved differently in different countries because the timing and nature of economic shocks and financial crises have differed across countries and, just as importantly, because the governments in these countries responded in different ways to these crises. That is, the evolution of financial systems has been shaped by market failures that elicited different types of regulatory responses, which then favored either a market or an intermediation orientation.

Second, stock markets have historically been more significant in countries that have pioneered the development of new technologies and industries (the United States and the United Kingdom), whereas intermediary-dominated systems have been more prevalent in economies that have been strong in developing industries pioneered in other countries. The reason is that newer technologies are characterized by a greater diversity of opinion about their future prospects, and stock markets aggregate such diverse opinions into informative signals more efficiently than banks [see Allen and Gale (1999)].

Third, the traditional notion that the greater the competition among banks the better is debunked by the authors. They model the highly fragmented United States branch banking system with the twist that depositors face search costs in identifying the bank they want to transact with. In this case, the equilibrium with many single-branch banks is surprisingly identical to the monopoly equilibrium. A duopoly with each of two large banks operating with a large number of branches yields the competitive outcome. This result is reminiscent of the Satterthwaite (1979) and Pauly and Satterthwaite (1981) finding that in reputation-goods markets with consumers facing search costs, the equilibrium price is *not* monotonically decreasing in the number of sellers. In other words, the market may become *less* competitive with more sellers.

Fourth, Allen and Gale assert that the theory of the firm should be integrated with the theory of financial systems for two good reasons. One is that financial system design has obvious implications for corporate governance in the "real" sector; observe the different corporate governance mechanisms in the United States, Japan, and Germany. The other is that financial sector imperfections lead companies to *internalize* financial tasks themselves, becoming intermediaries of sorts. Examples of such internalization are the use of retained earnings to fund investments, diversifying, hedging, and the mergers of cash-poor and cash-rich firms. This observation, which is consistent with Zingales's (2000) argument that we can no longer develop the theory of corporate finance independently of the theory of the firm, is one of the most striking aspects of this book. I will say more on this a bit later.

Fifth, Allen and Gale present a strong and persuasive case that institutions are better at providing individuals with optimal risk sharing opportunities than are markets. The reasons are many, from the viability of certain forms of implicit contracts with institutions [see Boot et al. (1993)] as well as the beneficial effects of long-term institutional relationships that permit the intertemporal smoothing of investors' returns. This, in a sense, is the heart of this book, and it also reflects many of the articles the authors themselves have published. Allen and Gale note that they view their book as providing a message that is counter to the current wisdom that market-based financial systems are always better than institutions-based systems. Their point is based on their thesis that there is a trade-off when markets are incomplete, and this trade-off stems from the fact that market dominance may come at the expense of risk sharing.

Finally, Allen and Gale argue that financial crises can be either good or bad. Even though financial crises impede banks' ability to smooth investors' returns, the optimal policy should be to eliminate the allocational distortions created by the crisis—costly asset liquidations in particular—rather than the crisis itself. Avoiding a crisis at all costs may be harmful. The reason is that optimal risk sharing requires low returns to be spread over as large a group of individuals as possible. A banking crisis makes returns to bank deposits contingent on the state of nature and can thus improve risk sharing. Moreover, the evolution of many financial systems has been shaped by how government regulators responded to financial systems crises. For example, crises like the Mississippi Bubble caused a loss of faith in markets in continental Europe and played a big role in the reliance on bank-dominated systems. Nonetheless, from a policy standpoint, Allen and Gale seem to conclude that neither system is immune to a financial crisis (nor may such immunity be desirable).

My overall assessment of this book is extremely positive. It is a very valuable addition to the growing literature on this important topic and will help guide future research. Having said that, there are some areas where one wishes the book could have delivered more.

First, conspicuous by its absence is any discussion of emerging markets. This is not an oversight. The authors are very explicit about their focus on developed systems. Yet some of the most interesting research issues to focus on in this area are in emerging markets. Good research articles on this topic are scarce, but the need is great. Allen and Gale could have done a great service if they had included a chapter outlining their view of a promising research agenda on this topic.

Second, the issue of behavioral irrationality—optimism, overconfidence, and so on—perhaps deserves a chapter. One of the roles of institutions as well as markets is to counter the effects of individual irrationality (through aggregation, competition, and other mechanisms). It would be interesting to examine how different financial systems cope with different forms of individual irrationality. A promising start is provided by Manove and Padilla (1999), who show how optimistic entrepreneurs may lead competitive banks to be insufficiently conservative.

Third, the treatment of the integration of the theory of the firm and the theory of financial systems leaves one hungry for more. I find this to be one of the most exciting parts of the book, and I felt that the discussion left me far from sated.

Fourth, I also believe that the theory of the financial systems needs to consider the impact of social attitudes on regulatory initiatives that shape financial systems. For example, I suspect issues like corporate socialism and the need to minimize social frictions through the reduction of distributional inequities resonate better in Continental Europe than they do in the United States. It would not surprise me if this has had some role to play in the selections of different systems in different countries. Thus, it may be time to look seriously at how politics and economics interact in financial system design. See Kroszner and Strahan (2000) for an interesting analysis of how politics have shaped bank regulatory reform in the United States.

Finally, I think a chapter on the blurring distinctions between markets and institutions would have been useful. Markets are little more than collections of institutions, and institutions operate with internal markets. Securitization and mutual funds are examples of these blurring distinctions. This raises interesting research issues that I am sure the authors have views on. It would have been helpful to have had an opportunity to see them.

All this having been said, this is an excellent book and one that I'd highly recommend. There are two simple questions one must ask in judging a book like this: (1) Did it inform the novice well? and (2) Did it help a person already doing research in this area? As for (1), I believe there is an enormous amount of valuable information for a person who wants to learn about financial systems, so much so that I intend to include this book as a reading for the doctoral course I teach. As for (2), I was able to come up with a number of interesting research ideas while reading the book, as I am sure will others interested in this topic.

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