modern theories of international trade under imperfect competition with assumptions about market operation under 1992. He sketches the circumstances in which European industrial policy would be welfare-enhancing and then illustrates with a discussion of the (currently segmented) EC car market.

Steve Thompson
School of Management, UMIST and Economics Department,
Bentley College, Waltham, MA 02154, USA

Lawrence White, The S&L Debacle (Oxford University Press, Oxford, 1991) pp. 308.

The book analyzes the crisis of the U.S. thrift industry during the 1980s. The author, academic and regulator of the S&L industry from 1986 to 1989, provides a detailed nontechnical study, based on economic principles, of the development of the crisis, its main causes and consequences, and the regulatory responses attempted. The inquiry includes an examination of the structure of the industry and its regulatory framework, as well as an assessment of the public policy lessons that can be extracted for the reform of banking regulation and of the future of the S&L industry.

The contention of the author is that the explanation of the crisis must be found in a combination of structural factors which were aggravated by incomplete and sometimes misguided regulatory responses, and not in widespread fraud. In essence, the thrift industry was focused narrowly on long term fixed-rate mortgage lending taking deposits at regulated rates. When in the late 1970s interest rates increased and money market funds started attracting depositors by offering high rates, the industry suffered important capital losses. Deregulation, in the form of expanded borrowing and lending capabilities, followed, but prudential requirements and supervision were not increased accordingly. In fact, they were decreased, yielding powerful incentives to take excessive risk given limited liability of bank owners and managers and the existence of deposit insurance. Unchecked rapid growth and risk taking brought disaster: an enormous increase in failures and, consequently, in the obligations of the deposit insurer (FSLIC). Nevertheless, a substantial part of the industry did not follow the high risk strategy although industry lobbying helped to delay needed action. Efforts by the S&L's regulatory agency (FHLBB) to control the crisis were implemented once the fundamental damage had been done. In 1989 both the FHLBB and the FSLIC were abolished and new legislation enacted by the U.S. Congress. This legislation allows the clean-up to continue but, according to White, at the cost of taxing the healthy part of the industry and neither establishes a permanent funding mechanism for deposit insurance nor implements necessary reforms.

Two recurrent ideas permeate the analysis of the crisis and the proposal for reform presented by the author. First, the (historical) accounting method on which banking regulation is based is flawed. This is so because it is a backward-looking method to keep track of the value of an institution which, in addition, gives incentives to bank managers to hide losses and overstate its networth position. A move to market value accounting is strongly advocated as the most important needed reform. White provides arguments against the dismissal of market value accounting as unfeasible. However, it should be pointed out that banks hold illiquid assets and provide liquid liabilities. The assets (loans to entrepreneurs, for example) are illiquid precisely because there is no market to trade them due to a basic asymmetric information problem. A question arises then about the proper 'market' valuation of those assets which cannot be securitized. Second, the principles and tools of insurance, and chiefly risk-based premiums, should be applied to deposit insurance. Other necessary reforms include: improved capital standards and early intervention and disposal of insolvent institutions to curb risk taking incentives; full (100%) coverage of deposits backed by the Treasury to prevent runs; and the use of long-term subordinated debt to provide enhanced monitoring incentives. The 'narrow bank' proposal (with required investments in safe assets) is seen as a radical and possibly unnecessary way to accomplish these reforms.

The analysis presented by White is clear, well documented and grounded on sound economics. This is most welcomed on the face of a crisis which roots do not seem to be well understood by too many people, including politicians. There are two areas, however, in which I would have liked to see a more refined analysis. The first concerns the effects of deposit insurance on competition and in particular on the incentives for high risk institutions to overbid sound rivals to attract deposits. This seems to have been an important dynamic element in the development of the crisis. The second concerns the political economy of regulation. Why did elected politicians and regulators use a policy of forbearance which has proved so costly? Regulatory failure must be explained. Incentive theory could enlighten the pitfalls of the regulatory process and the role of lobbies, short-termism of elected politicians and regulators, and potential collusion between industry and regulators.

I strongly recommend the book to anyone interested in banking regulation today. Academics will find plenty of issues to research. Practitioners, regulators and politicians will find a coherent framework to think about important aspects of the banking industry and proposals for change.

Xavier Vives
Institut d'Anàlisi Econòmica (CSIC), Universitat Autònoma de Barcelona, 08193-Bellaterra, Spain