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CHAPTER 1

Financial history: Lessons of the past for reformers of the present

Gerard Caprio, Jr., and Dimitri Vittas

History teaches nothing, only punishes those who do not learn its lessons.
Charles Maurice de Talleyrand-Périgord (1754–1838)

Financial systems in many developing and transitional economies are in a state of flux, in many instances emerging from periods of significant repression and more recent episodes of financial reforms, with little to show for the changes. Indeed, financial crises or more silent forms of financial distress appear to be widespread, from Argentina, Mexico, and Venezuela, to many countries in Eastern Europe and the former Soviet Union, to those in Africa and parts of Asia. For a variety of reasons, financial reforms are difficult to manage, as they involve changing incentive systems and institutions. Also, finance – in particular, banking, the heart of developing and transitional economies' financial systems – is different from other sectors or industries in that failures can spread in a contagious fashion from one institution to another, with deleterious effects on the rest of the economy. And in part as an effort to cope with contagion, some or all of the liabilities of banks often carry an implicit or explicit government guarantee, creating a problem of moral hazard.

In addition, a major difficulty with attempts to reform finance, whatever the initial conditions, is that the reformers virtually always take as given the goal, namely, to move their financial systems toward the general model that has been adopted in most OECD countries today. This model, to the extent that one can generalize, is based on a safety net, in the form of government ''insurance'' for deposits, a prescribed minimum capital adequacy ratio, and government supplied supervision. Not only do these latter financial systems have unresolved problems of their own – for example, the significant bank insolvency problems in France, Japan, Scandinavia, and the United States during the 1980s and 1990s – but they require a rich institutional environment that cannot be transplanted to developing and transitional economics overnight or even in a few years, if at all. In particular, the upgrading of su-

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pervisory systems to ''world class'' standards, without which government guarantees are dangerous, appears to be difficult and time consuming. It is also noteworthy that the prescribed capital ratios are low (8 percent) compared with those found in OECD countries during their industrializing period.[1]

Fortunately, the present OECD country experience is not the only one available to emerging markets today; modern banking has been in existence since the fourteenth century, and the late eighteenth century and especially the period of the nineteenth century through the 1920s are rich with the experience of financial systems that did not have much supervision or a government safety net, both of which began during and following the depression of the 1930s. This period is also relevant to developing and transitional countries today, because it is the era when OECD countries were moving from a reliance on agriculture and various commodities to industrial development. Given the relevance of these periods, the conference from which this chapter takes its title was organized to investigate various aspects of the evolution of financial systems and to draw out lessons for emerging economies today. This chapter summarizes the key lessons, including the following: the rise of central banks; debates on how to make banking safe, sound, and better able to fulfill its intermediary functions; the relative efficiency of universal banking (compared with the Anglo-American commercial banking model); and the role of savings banks, nonbanks, and securities markets in development. Section I concentrates on the lessons that have been deduced from a review of the rise of central and commercial banking. The principal questions posed are these:

- What is the role of the central bank and how have these institutions achieved greater independence?
- If financial regulation and supervision is so difficult, is free banking an option, and what does the most successful case of free banking teach us?
- How important is branching and other forms of bank diversification?
- Can varying liability limits help ensure safer banking?
- Is universal banking more efficient than the Anglo-Saxon separation of commercial and investment banking?

Unapologetically, this volume concentrates on banking, since in most developing and transitional economies, at least two-thirds of all financial system assets are in central and commercial banks, with this proportion rising to as much as 90 to 95 percent in the least-developed countries. Nonetheless, nonbanks can play a vital role in the provision of financial services. Nonbanks

[1] For example, in the United States capital–asset ratios routinely ranged from 15 to 35 percent in the latter part of the nineteenth century through the 1920s (Saunders and Wilson, chapter 6, this volume). According to Tilly (1966) even higher ratios – 25 to 50 percent – were recorded for German banks in the period 1830 to 1900.

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provide a countervailing competitive force to banks, they reach segments of the population and economic sectors that may be neglected by banks, and they may help reform overstretched and unsustainable social security systems that may undermine macrofinancial stability and inhibit growth and development. Section II therefore addresses issues related to savings banks and nonbank finance. It asks:

- How did thrift institutions emerge and can they play an important role in developing and transitional economies?
- How did securities markets arise and how proactive must government policy be in order to stimulate their development?
- How did pension funds develop and become major forces in developed countries' financial systems?

Finally, Section III summarizes the editors' views of the most important lessons for developing and transitional country authorities.[2]

It should be noted that this chapter does not offer magic cures that, if taken, would alone suffice to ensure a dynamic and efficient financial system in which all deposits are safe, all loans are performing, all good investment projects are financed, and all bad ones rejected. If there had been such a successful model for finance, it would be clear from country experience – and although observers often have been quick to claim such merits for many financial systems, these claims rarely endure. Careful examination of cross-country and historical evidence can instead only lead one to conclude that recommendations for any country's financial system need to be ''tuned'' to the institutions and culture of the country. This volume was inspired by the many cases in which those engaged in financial reforms appeared either to ignore financial history or to proceed as if the lessons were clear and definitive. In the spirit of the this chapter's epigraph and as highlighted by Forrest Capie in Chapter 2, the temptation to draw lessons from history can be overdone. Sometimes history does not teach clear lessons, or stated differently, one has to be extremely careful in applying the so-called lessons. To the editors of this volume, a better acquaintance with history is a necessary ingredient in this endeavor.

That caveat notwithstanding, what are the general lessons? For government authorities, perhaps the two most important factors that should be kept foremost in mind in reforming financial systems are diversification and incentives. Regulators need constantly to verify that banks and other intermediaries can and do diversify their risks and that owners face incentives that will induce them to behave prudently. Although the latter is of prime im-

[2] The following chapters focus on lessons for developing countries, transitional economies – those in transition from socialism to a more capitalist system – and emerging markets (usually the often-changing subset of the two groups that attracts the attention of international investors). The editors believe that the chapters are relevant for all three groups. We will accordingly use ''emerging market'' to mean any of the developing or transitional economies.

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portance, there are different ways of accomplishing this goal, which in turn provides the basis for some of the differences observed over time in financial systems. Another general theme concerns the importance of reputation, equally important for central bankers – their reputation for noninflationary policies – as for owners and managers of intermediaries – their reputation for sound, as opposed to Ponzi, finance.[3] Many of the following lessons put some flesh on these quite general recommendations and elaborate their consequences.

I On the role of central and commercial banks

For several hundred years after the rise of banking during the Renaissance, banking systems functioned without a central bank, and these systems experienced serious inflationary and deflationary shocks associated with reserve flows, among other factors. Central banks emerged, as Forrest Capie explains in Chapter 2, to fulfill both the macro function of inflation control as well as the micro and macro role of ensuring banking system stability. Early central banks originated as national banks that were induced to assume more of a role as a lender of last resort, and it is this function that Capie notes was an important factor leading to their divestiture of commercial banking functions to avoid any conflict of interest. Also, it is often argued that it is difficult enough to excel at central banking functions, so one might suspect that central banks would perform better with fewer distractions.[4] Interestingly, transitional economies appeared to have relatively quickly separated commercial and central banking functions. However, the appearance of a move to a two-tier banking system is somewhat deceptive in economies where the central bank refinances a significant amount of credit by state-owned banks, a phenomena that has been occurring in some transitional economies.

Increasing central bank independence is intellectually fashionable in many parts of the world today, and Capie tells us why and how independence was achieved in the past. He notes that early central banks in effect had a special source for their independence: the absence of the notion that fiscal policy could be used to influence macroeconomic aggregates, such as employment and output. This notion did not become popularized until the Great Depression and the early post–World War II era. Without this presumption, and with a gold standard system, the few central banks in existence – the Bank of England and a dozen other institutions – were able to maintain a high

[3] Ponzi, or pyramid, schemes are those that often offer outrageously high rates of return, but pay them through the funds of new investors. ''Ponzi finance'' then refers to the tendency of intermediaries to take progressively greater risks to cover up for earlier losses.

[4] Hammond (1956) describes how the Second Bank of the United States – which, like the Bank of England, was a private institution – coped with this conflict of interest during the 1812–1932 period. As is easily imaginable, it is difficult to construct an incentive system for an institution with both commercial activities and central banking functions.

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degree of independence.[5] Although many economists have long since concluded that changes in budget deficits will not have permanent real effects, the short-run orientation of many politicians, along with more widespread beliefs in the role of the state in providing an array of services and safety nets, has led to more regular attempts to use fiscal policy to influence macroeconomic aggregates. If authorities wish to increase the likelihood that the central bank will be able to resist pressures to accommodate future fiscal demands, then measures such as significantly lengthening the terms of office of central bank governors and making it difficult to remove them would tend to give monetary policy officials the longer-term view that, in effect, was formerly induced by the gold standard.[6]

A second lesson on central banking that is of importance to policy makers is that reforms take time. While it is fashionable to try to introduce market-determined interest rates and open market operations, Capie recounted in the seminar discussion period that the Bank of England took about fifty years to move from direct to indirect implementation of monetary policy. To be sure, as the first real central bank, in the sense of recognizing its lender of last resort functions, and the first one to make this shift, it is understandable that changes proceeded slowly. However, although this experience can help accelerate change in developing countries today, organizations and institutions still take time to change and acquire needed skills, such as the management of interest rate risk, and officials in particular need time to feel comfortable without direct controls. Since it is important that organizations competing in markets for funds be solvent, ensuring that the participants are and likely will remain solvent will also take some time. Thus, moving from direct to indirect implementation of monetary policy should be seen as a problem of financial development that will have to stretch over many years – say, a decade – and the lower the initial income level, the longer the expected time for this transition.

Finally, central bankers need to acquire credibility, or a reputation for noninflationary behavior, and this process also takes time. Given the role of the gold standard in helping to tie the hands of central bankers, Capie implicitly provides support for those advocating fixed exchange rates or, even more stringently, a currency board system for developing and transitional countries needing to establish such reputation quickly. The modern examples provided by Estonia and Argentina suggest that this is appreciated by some authorities today. History, however, also suggests that such arrangements are transitory, in part no doubt due to the well-known difficulty of persuading countries with surplus funding to adjust or to make fiscal transfers to weaker

[5] Of course, with a textbook gold standard, one might say that central bankers had little to do in terms of worrying about the growth of monetary aggregates. However, the gold standard was not quite an automatic textbook system, as suggested by Triffin (1964).

[6] Alcazar (1995) suggests that longer terms are more effective than other methods at increasing central bank independence.

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parts of the currency zone.[7] Thus, authorities should look to additional ways to achieve reputation for their central banks, such as through long terms of office for their governors and budgetary independence from the rest of government.

Whenever central banks are criticized for their performance, or seem incapable of improving economic outcomes and possibly worsening them, inevitably there are calls to do away with these institutions and instead adopt free banking. This term can have many meanings. In the narrow sense, *free banking* means both free entry into banking and the ability of banks to issue their own paper, or notes. So conceived, free banking eliminates or appears to deny the need for a central bank, which is usually given a monopoly power on note issue and the ability to serve as a ''gatekeeper'' regarding entry into the system. The Scottish example (in the 150 years up to the Peel Act of 1844) comes the closest to satisfying the criteria for free banking, and it appears to be a successful case. During that period, Scotland was a rapidly industrializing country, starting from a low level and actually overtaking England. One of the fears of removing entry barriers in banking is that it might attract unsavory elements or, more kindly, those who are willing to engage in excessive risk taking. Kroszner makes clear in Chapter 3 that one important ingredient in the Scottish case was the unlimited liability of the owners of ''free'' banks. This feature likely led to the requirement of high levels of capital to protect the personal fortunes of bank owners. True, as with any regulatory requirement, its spirit can be evaded by having a part owner who is hard to find, but if laws dictate that locating reluctant owners is the duty of the other owners and the penalty for evading the law is high, such a requirement would likely be effective in motivating owners to ensure that their bank is prudently managed. In Scotland, reputation, rather than law, appears to have been more important in preventing such abuses. Diversification was also important in Scotland, in that free branching not only helped to increase competition and led to some of the innovations noted by Kroszner, but also contributed to the stability of banking.

If unlimited liability is more effective in inducing safe and sound banking, then one might expect to find lower losses and less evidence of contagion, and this is suggested by Kroszner, as well as by Saunders and Wilson in Chapter 6. Kroszner notes that the Scottish experience was not entirely without a lender of last resort, as there were three large banks with limited liability, as well as the Bank of England, to call on in times of crisis. So although it is possible to argue that unlimited liability reduced the threat of bank contagion, the presence of these other institutions, widespread branching, and the ability to suspend convertibility temporarily might have also

[7] Caprio, Dooley, Leipziger, and Walsh (1996) also note the difficulty in providing lender of last resort support in a currency board regime. Although various regulatory changes can help narrow the range of shocks that will buffet a banking system, there is no way to eliminate systemic risk, suggesting that currency board regimes will be transitional devices.

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been factors. The case for unlimited liability is strengthened, however, by the fact that bank runs were more prevalent among English banks at the time, which of course also had the same Bank of England on which they could depend. To be sure, adopting free banking is not an all-or-none proposition: one could still have a central bank in charge of note issuance and yet have the higher liability limits and easy entry that allowed bank owners to reap the benefits. Free banking might be attractive where the ability to supervise banks effectively is limited – though some critics might contend that this is a wide sample indeed.

Saunders and Wilson also reviewed higher liability limits, in the form of the double liability limits in some states in the United States, a practice that came into existence at least in part following the experience, beginning in 1837, of free banking with limited liability (and the popular stories of ''wild-cat'' banking). According to the double liability system, each owner was liable for a post-closure assessment of an amount equal to his or her capital, which would have already been drawn on to cover losses. As Saunders and Wilson indicate, this practice led to fewer involuntary closures, as well as more voluntary mergers, and appeared to have played an important role in insulating depositors against loss. Thus, some form of higher liability limits on bank owners appears to be worth consideration in emerging markets as a way of increasing owners' incentives to monitor their managers. As noted by Caprio (1995),[8] developing and transitional economies are risky environments, not just due to policy changes but even more so due to their small size. Hence, applying the same capital requirement – in the form of the Basle guidelines, which were devised for relatively large and diversified economies – to smaller and undiversified countries could be dangerous. Raising liability limits induces the owners, rather than officials, to set capital ratios, which may be convenient since it is difficult for officials to know how high capital ratios should be raised in different economies.

It is possible that raising liability limits too high might lead to a suboptimal supply of financial services. However, in neither the Scottish nor the U.S. case does this appear to have been a problem: both economies were the ''miracle'' economies of their era, and as Kroszner illustrates, even with unlimited liability there was notable innovation by the Scottish free banks, including a form of option contracts.[9] Thus, this drawback does not appear

[8] That paper also notes other methods to improve incentives facing bank owners, such as arbitrarily raising capital requirements, limiting entry to build up franchise value, free banking, and narrow banking. It should be recognized that all of these assume private owners. Joint liability, such as through participation in a clearinghouse association, would also improve private incentives. For state-owned banks, there is no clear evidence that any of these options would have an effect, as they assume owners that are motivated by profits.

[9] Interestingly, these option clauses represented a market solution to bank runs, in that they gave the issuing bank the right to defer payment on bank notes, so that holders would get either what they were due when they presented the note or, alternatively, that sum plus interest in six months. As Kroszner notes, these options were quite popular until banned, largely at

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to be too severe, though it would be reassuring if there were more cases of higher liability limits on which a conclusion could be based. But for officials beset by financial instability and underdeveloped supervisory capacity, higher liability limits appear to be a potential solution ensuring safe and sound banking.[10] Completely free banking – including removing monopoly of note issuance – need not be adopted as part of the same reforms, though as more countries are willing to consider currency board arrangements, they might even consider this radical step. For now, a system of freely competing currencies appears to be an idea whose time has not yet come.

Officials intent on reforming their financial systems should keep in mind that most banks – and banking systems – encounter solvency problems (or bank crises) because they fail to diversify. To be sure, there are myriad reasons for bank failure, such as connected lending, regulatory restrictions, and an inability on the part of bank management to plan. Regulatory restrictions are the easiest for authorities to correct in principle. In the United States, the battle to keep as many regulatory powers as possible at the state level, coupled with a fear of concentrating of wealth and political power, led to the imposition of a prohibition on interstate branching, and in many states there were further restrictions limiting banks to a single branch. Calomiris (1992) has shown that states that permitted branch banking enjoyed more stable banks and lower losses per dollar of deposit than did unit banking states. Michael Bordo, Chapter 4, this volume, shows quite convincingly how branching restrictions led to a much higher failure rate in the United States than in Canada during the 1870–1980 period. Canada experienced the same shocks and was a smaller economy, yet had a much lower bank failure rate due to nationwide branching, which led to far fewer banks. Indeed, he notes that during the international business cycle contraction – most severe in the 1870s and 1890s – the contagion effect led to bank runs and a further contraction of output in the United States, but Canada, which was not spared the effects of international forces, did not suffer further contractionary effects because of its better-insulated banking system. Having a small number of banks also facilitates the merger process when one gets into trouble, as the remaining banks can clearly see the problems they might encounter if depositors at the insolvent bank suffer losses; having fewer banks also increases their incentive to supervise one another, as the costs of contagion are more clearly visible and the benefits from mutual oversight easier to appropriate.[11]

the behest of the large, limited liability banks, who were losing business, because the options made small banks' notes more attractive.

[10] The authors recognize that this suggestion may not be viewed as practical, given the current regime in industrial countries. Still, the greater risks and volatility in developing and emerging country markets may require different solutions than those in the OECD economies.

[11] Champ, Smith, and Williamson (1991) argue that a high degree of currency elasticity in Canada may also have figured prominently in explaining the greater degree of banking stability there. This may be the case, but the tendency of Canadian banks to issue banknotes

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Thus, with fewer banks there may be a form of implicit joint liability, and Calomiris (1992, 1993) has substantiated these benefits in the case of U.S. clearinghouses, for which the joint liability feature was important.

It is likely that with the benefits of greater stability, there may be costs due to less competition. However, Canadian authorities appear to have offset this possible effect by keeping their economy open. Hence, this case might be useful for small emerging markets: for many countries the small size of their economies means that, even with national branching, their banks will still be concentrated, but then there is little choice, if stability is desired, but to permit these banks to hold assets overseas. Although many observers have noted that banks tend to make losses if they stray far from their home base, holding assets abroad need not mean lending there. Instead, banks in small developing countries could hold securities – such as shares in internationally diversified mutual funds – which would greatly limit their risk.[12] For example, Mexican banks were seriously weakened by the collapse of the peso in late 1994 and early 1995, and it is argued that the subsequent recession there will be worse due to the banks' weak condition. If Mexican banks had held, say, 50 percent of their portfolio in the form of internationally diversified mutual funds, they would be in much better condition today and would be better able to lend and thereby to support a recovery. Similarly, if Japanese banks had done the same in the 1980s, they would be in commensurably better shape at present.

As noted earlier, bank portfolios might be concentrated due to an inability to plan, as evinced in the failure to analyze and comprehend the extent to which various parts of their loan book – oil, land, and construction in the case of Texas banks – were correlated. Or they engaged in simpleminded forecasting,[13] such as the assumption, when asset prices or commodity prices rise, that the price rises would continue. This inability to plan should be understood not as an exogenous factor but rather as a consequence of poor incentives. If bank owners will reap a large reward from prudent bank practices, then that is the activity in which they will tend to engage. Thus, Caprio and Summers (1996) argue that as banks' franchise value declines, owners will invest less effort in ensuring safety and soundness, and Keeley (1990) links the declining franchise value of U.S. banks to lower capital ratios.

countercyclically was not sufficient to prevent Canadian authorities from having to step in and assume a more active role prior to the establishment of a central bank in 1935. Indeed, the concerns that currency elasticity was insufficient were important in mustering support for creating a central bank (Shearer, Chant, and Bond 1995).

[12] As should always be the case, attention should be paid to issues of asset liability management. Thus, banks with mostly short-term deposits would need to invest adequately in funds holding short-term, high-quality bills, while those with longer-term liabilities could hold some medium- and long-term bond funds.

[13] One could also classify interest and exchange rate mismatches as due to an inability to plan. De Juan (1987) describes in greater detail this process by which bankers descend along the path from being good bankers to bad.

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Again, then, there appears to be a case for making sure that banking is profitable, and in emerging markets this usually means reducing the often excessive taxation of financial intermediaries. Attention to franchise value is also relevant in considering the role of fraud in bank failure. The temptation to ''loot the bank'' will grow the lower the franchise value is in relation to the short-run gains from looting (Akerlof and Romer 1993), and fraud is a popular form of looting. That fraud is often found when banks fail is thus not surprising, since when banks' net worth becomes either low or negative, there is less incentive for owners to police employees (or restrain themselves). This is especially true in a world in which cultures and legal systems place less importance on arms-length transactions and where the costs associated with a damaged reputation can be avoided by migration.

Insufficient diversification might also be due to connected lending, in which banks lend to related businesses – those that they own or are owned by – or to businesses owned by friends, family, or by those willing to pay a bribe for a loan. Even with proper regulations, history suggests that banks demand alert supervision to prevent these abuses, coupled with severe penalties in the case of transgressions. In nineteenth-century New England, insider lending was popular, yet the importance of maintaining a good reputation appeared to be a key factor in restraining abuses (Lamoreaux 1994). Regarding ownership links, it should be noted that banks often arose in connection with nonfinancial enterprises, as was the case of Japan in the last third of the nineteenth century. However, as Frank Packer reminds us in Chapter 8, this volume, as soon as these banks acquired some size, they went from being cost centers to specializing in short-term trade finance and became highly profitable. They later were split off from the commercial firms and – presumably because prudent banking was sufficiently profitable – functioned as independent banks, some of which failed in the 1920s, while others remained quite successful. The Japanese also adopted a ''hard bankruptcy'' policy that suspended transactions of firms that were unable to pay their notes. Thus, clear incentives matter. Also, when banks control firms – as in Japan and in Germany – excessive lending to related firms appears to be less of a problem than when firms control the banks, as in the case of Chile during the 1970s and early 1980s.

Should ownership links be severed and banks be constrained to commercial banking narrowly defined, or is universal banking the superior model? Research has not been able to answer this thorny, long-standing debate. Kennedy (1987) argues that in response to banking crises of the mid-nineteenth century, U.K. banks retreated to develop the most efficient short-term markets in the world but cut back on lending to industrial firms, whereas German universal banks continued this lending, in part due to their superior information and control over corporate clients, related to bank managers' ability to buy and underwrite securities including equity and their positions on corporate boards. Charles Calomiris, chapter 7, this volume, also shows con-

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