This volume summarizes the key lessons of financial history for emerging markets and developing economies today, including the rise and role of central banks, debates on how to make banking secure and sound, 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. Two lessons that should be kept in mind in reforming financial systems are the importance of incentives and diversification. Robust financial systems require incentive systems that reward prudent risk taking and encourage sound portfolio diversification. In addition, reputation has proved to be important: Central bankers must demonstrate anew why they have earned a reputation for noninflationary policies, and private intermediaries must similarly demonstrate again why they have earned a reputation for sound, as opposed to Ponzi, finance. Attempts to reform financial systems without due allowance for the time and effort to develop institutions, including their reputation, are likely to prove short-lived.
Reforming financial systems
Reforming financial systems

Historical implications for policy

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Foreword

Until the early 1980s, developing country financial systems were widely regarded as passive funnels for external resources. Development banks, mostly established with the help and encouragement of the World Bank, were expected to take the lead in identifying and financing major development projects in industry and infrastructure, as well as in supporting small-scale farmers and the poor. When attention focused on the performance of development banks, it became clear that most of them were insolvent. The Bank then quickly began using commercial banks as intermediaries, but it was soon discovered that commercial banks were also mostly in financial distress.

In response to these problems, the main goal of the Bank’s work in the financial sector became the task of reforming finance and putting domestic financial systems on a safe and sound footing. This initially involved rationalizing and deregulating interest rates and credit policies. The focus was then widened to a restructuring, recapitalization, and privatization of banks, followed by a stronger emphasis on capital market development. More recently, the strategy has been directed to what might be called the prerequisites of sound financial systems: better infrastructure and better plumbing, that is, better-defined property rights, more effective enforcement of contracts, improved information flows, and stronger supervision.

In refocusing the strategy, there is a wealth of historical experience from which we can draw. However, attempting to transplant institutional structures that are currently in fashion in OECD countries without sufficient regard concerning their relevance for developing countries overlooks the lessons of financial history. This book brings together a number of papers that were presented at the seminar entitled Financial History: Lessons of the Past for Reformers of the Present on May 23–25, 1994. The chapters address some intriguing questions in financial sector development: What is the role of the central bank? When, if ever, should sovereignty be sacrificed for currency boards? If supervision cannot be effective, is there a case for “free” banking? Is deposit insurance a good idea for developing countries? Does finance in small economies need to be regulated differently than in larger neighbors? What models of banking and financial structure should we look to for de-
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Developing countries: Anglo-American, Japanese, or Continental? How can nonbanking financial intermediaries, including, in particular, thrift institutions and pension funds, contribute to development?

This book draws on the wealth of historical experience as reviewed by a group of eminent scholars in their field. It shows the many lessons that can be learned from history and also highlights some pitfalls that can be avoided. History cannot be transplanted, but it can shorten the distance to the future.

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