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Edited by Harold James, Håkan Lindgren and Alice Teichova
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1 Introduction

HAROLD JAMES

The financial history of the interwar years is turbulent. All the papers presented in this volume examine major crises in the developments of financial systems, and are concerned with the character of institutional responses to these crises, as well as with the pathology of financial behaviour.[1] Financial institutions frequently bore a great part of the strain of adjustment to profoundly altered conditions on the world market as well as in the world monetary system.

The First World War and the post-war inflationary and then deflationary traumas of the early 1920s described by Forsyth for Italy and Feldman for Germany set the points for policy responses, one decade later, to the world depression. Larsson tells the story of the major Swedish banking crisis of the early 1920s, and Vanthemsche develops a similar analysis of the severe shock given at the same time to Dutch banking. Boross looks at the investment strategies of one of the great Hungarian mixed banks, and Mosser and Teichova give an analysis of the first and most famous victim of the 1931 crisis, the Vienna Credit-Anstalt. Drummond looks at a country which experienced no major bank collapses, and explains why the Canadian system was so immune.

Kunz and Fletcher examine the debates about rejoining the international gold standard, and about how the international order might affect domestic conditions. They then detail the circumstances of 1931 in which Britain, in September, and Japan, in December, left gold. Mazower also deals with the Greek currency depreciation of April 1932. The weak attachment of Canada to gold plays a major part in Drummond's account. Vanthemsche considers the 1935 Belgian devaluation, which followed in the wake of a severe financial panic and banking crisis. Mazower and Fletcher point out that their cases, Greece and Japan, which had undertaken very drastic currency depreciations, also had exceptionally impressive export performances in the 1930s. Recovery in Sweden and Britain also followed devaluation, though it is much less certain that the mechanisms of recovery lay in export performance.

Two themes run through the papers: did adherence to the new monetary order of the international gold exchange standard in the 1920s increase vulnerability to financial disturbance? Secondly, were some kinds of financial structures – in particular those with a prominence of mixed or universal banks with long-term ties (credits but also equity participations) with industry – particularly vulnerable?

In making comparisons, one problem is instantly apparent. Clearly the countries considered here were at very different stages of development. Greece had the least advanced industry, and might be characterized as a dualistic economy, in which islands of modernity existed in the middle of a sea of backwardness. Japan also stood far back on the gradient of development, with a per capita productivity level estimated by Angus Maddison to be about a third of Britain's. Germany, Britain and Belgium were mature industrial economies, but suffered badly from the aftermath of war. The First World War did not affect the Netherlands or the Scandinavian countries directly, and the involvement of major industrial powers in combat offered non-belligerents a chance for accelerated development. By the end of the 1920s, Denmark and also Sweden had reached high levels of productivity.[2] Austria, Hungary and Italy were less advanced, and had sustained major wartime damage.

The financial systems of all these countries also stood at different points in their emergence; but if we use Raymond Goldsmith's financial intermediation ratios as a guide, we find a very different ranking order from that found for per capita income or labour productivity. In fact the correlation between the financial and the income or productivity indicators appears on the whole quite arbitrary.

It is perhaps unsurprising that in 1929 Greece came lowest in the financial rank order (financial assets were equivalent to 65 per cent of GNP), or that Germany's ratio (89 per cent) or Belgium's (85 per cent) represent figures much reduced in consequence of the aftermath of great inflations, and below Italy (95 per cent), Canada (101 per cent) or Great Britain (131 per cent). But it is a surprise – though one that points optimistically into the future – that Japan appears in banking massively over-developed in relation to her income, with a ratio of 223 per cent, ahead even of the USA (129 per cent). The Scandinavian countries share these relatively high ratios: Sweden 138 per cent, Denmark 186 per cent and Norway 241 per cent. And, *before* the First World War, Germany like Japan had also been apparently over-banked also.[3] It is clear then that whatever else, the stages of financial development hardly coincide with the stages of economic development.

Moreover, there were dramatic and spectacular interruptions to the story of a progressive development of financial institutions and the economic order as a whole from one happy stage to the next. All these economies – from the most to the least developed – were affected by the great international crises – the post-war stabilization, and then the Great Depression and the currency destabilization that followed the sterling devaluation. One way of treating the issue of comparative analysis is to see how systems at different points in their emergence were altered under the impact of common international upheavals.

(1) What was the effect of adherence to an international system – that of the gold exchange standard – on domestic financial structure? Kunz points out that in the 1920s there existed an 'ideology of central banking', propagated by figures such as Montagu Norman, the long-serving Governor of the Bank of England, with a 'messianic fervour'. This doctrine required currencies convertible into gold at fixed rates, with independent central banks controlling domestic monetary developments in accordance with signals sent by movements of the international reserves (gold or convertible exchange – in practice dollars or pounds). The central banks would use their credit polity and their discount rate on bills supplied by the domestic banking system in order to regulate domestic conditions.

These institutions were supposed to recognize that in addition to domestic functions, they had an international role. As the advocates of central bank activity saw it, that role was not just to equilibrate international economic relations, but also to perform this by controlling the 'state of business activity', 'restraining where expansion seems secure and relaxing where business activity in the world at large is unduly declining'. In practice the task envisaged by Norman involved rather more restraint than expansion. He was shaped in his behaviour by the perception of the immediate post-war years that a shock was needed to weed out the unhealthy developments of the wartime inflationary period. As he formulated the view in 1921, 'a central bank should protect its own traders from the rapacity of other banks in his own country'.[4]

Adherence to this international system was invariably the price demanded in return for assistance and access to capital resources: either from the London or the New York markets, or from international agencies such as the League of Nations' Financial Committee, which was very much under the sway of the Norman doctrine. Being 'on gold' meant playing by the rules of an international game, and thus satisfying conditions for capital inflows set by the creditor countries – which in practice meant Britain and the USA, though by the end of the 1920s the French were also playing a major role. Adherence to gold would ensure that the excesses of the early 1920s, where (outside Britain and the USA) the belligerents of the world war or their successor states (in the case of the Habsburg and Ottoman monarchies) followed highly inflationary courses, could not recur. The gold standard provided a very visible marker for the ending of wartime inflationism and a return to responsibility.

Yet in the role expected of central banks there lay a problem. Their capacity to influence monetary developments varied enormously from country to country. In general, they could not use American-style open market operations to influence or control monetary aggregates, because the aftermath of inflationary government finance had brought very strict restrictions on Central Bank purchases of government securities. In Central Europe and Italy (which after the 1890s had developed a banking system that might be described as Central European in character), financial markets were dominated by large credit banks, which usually engaged in long-term financing of industry as well as in more conventional short-term businesses. They issued shares, gave current account credits and discounted bills; they often also held shares so that they often appeared to be industrial holding companies rather than banks more conventionally understood. Only in crises did central banks play a prominent role in discounting bills from the portfolios of commercial banks; in normal times the market operated relatively independently of central banks. In France the Banque de France very rarely held bills from the major banks; and in

Hungary the great banks prided themselves on never using the rediscount of the central bank. Forsyth traces the hostility to commercial banks on the part of the political establishment in Italy, and the relative weakness of the Bank of Italy, back to the pre-war Giolitti years.

Outside Britain where the contacts between the money market and the Bank of England were much more regular, central banks then needed to do something to assure the control that Norman, or the London and New York financial communities, or the League, believed to be an essential part of the confidence on which international capital flows might be based. But there was a paradox in that capital inflows – encouraged by the adherence to gold – were likely to give the commercial banks greater room for manoeuvre and to preserve an independence founded upon banks' access to domestic and increasingly international capital. They did not need to listen to the central banks. The result was that outside the Anglo-American world and Scandinavia, central banks were given an institutional interest in promoting crisis to guarantee their own control of markets. In such an event, the rediscount facilities of central banks might at last become central to the operation of the market.

Feldman describes the growing significance of the Reichsbank, the German central bank, as the post-war inflation developed, when he cites the Hamburg banker Max Warburg's description of the Reichsbank as 'our greatest helper': this was a novelty for Central European bankers. After the stabilizations of the German currency in 1923–4, the Reichsbank continued to play a major role – but only when foreign funds were unavailable.

Hungary and Austria had new central banks that were imposed as part of stabilization schemes under the auspices of the League of Nations; and most Latin American countries also only received central banks during the course of the interwar years. The same was true of Greece, where the largest commercial bank (the National Bank of Greece) simply issued notes. The new institution of 1927, the Bank of Greece, was created explicitly in response to Norman's international activity; but, according to Mazower, the abdication of central banking functions actually strengthened the old National Bank. It could now concentrate on its life as a powerful commercial institution, and did not depend on the rediscount of the central bank. The Greek problem then became the general one of Central Europe: strong commercial banks side by side with an inexperienced and weak central bank.

Drummond's counter-example offers an instructive test case of the consequences of not subscribing to the Norman regime of gold exchange standard and independent central banks. Canada, which until 1935 had no central bank, and where gold convertibility was mostly a fiction because the Dominion authorities would not release gold, in consequence was partially isolated both from external shocks and from domestic pressures for deflationary policies. Drummond presents a powerful case that 'if the Dominion authorities had really been attached to the gold standard, things might have been much more alarming'.

(2) It is easy to see why. Credit control and deflation looked like the easiest way of strengthening central bank influence. Yet financial structures and institutions are very vulnerable to deflation. The international interests of central banks in this way ran counter to the requirements of stability in the national system as a whole.

The deflationary experience of the interwar period can be summed up in this way: higher interest rate or restricted credit puts pressure on businesses to reduce inventories by lowering prices; falling prices reduce the value of securities against loans; banks at first demand additional securities to cover the loans, but when none are any longer forthcoming, they start to call in loans; borrowers are forced further to liquidate stocks; and prices fall still further in consequence. Banks call yet more loans, and the familiar vicious circle of 'debt deflation' described by Irving Fisher sets in.[5]

The deflationary process in the various national economies was a product of the international Norman system, a system which set its criteria for success in the degree of central bank control of domestic monetary markets as well as in central bank resistance to inflationary demands for government borrowing. Where central bank control was very limited, the economy might escape – at least to some extent – the deflationary pressure; such was the case in Greece in the early stages of the depression, when the Bank of Greece was expected to make credit scarce and tighten interest rates, but could not be effective because it had so little contact with the market. Obviously if other banks are able to lend more cheaply, and dare not depend on refinancing with the central bank, there is little that the central bank can do to restrict credit.

But there are other ways in which deflationary pressures were transmitted internationally. Falling world prices may have the same effect as deliberate attempts by national central banks to reduce loans. In this regard, Central European banking systems were especially vulnerable. Banks with large long-term loans to industry were threatened as price collapses threatened the value of their collateral. Banks with substantial share portfolios were vulnerable to declining security prices. They lost income as dividends were reduced or stopped; and in the longer run their solvency was affected by the declining value of their assets. This was a particularly powerful consideration in those countries with well-developed traditions of mixed banking: commercial and investment banking combined. Shares were sometimes also held in the expectation of favourable developments in the capital markets, and retained for longer than anticipated when those improvements did not set in. Here lay another cause of bank weakness in the later 1920s and early 1930s. The crises were particularly acute in the lands of the mixed banks.

Countries heavily dependent on primary products above all were vulnerable to a deflation transmitted through commodity markets. It was in particular the wheat price collapse that undermined both the Hungarian economy and the financial structure after 1929. This makes the Canadian example all the more remarkable. Here there was no universal banking tradition, so one potential source of trouble was removed. Most importantly, the government acted firmly to stop the transmission of a price decline affecting the debt pyramid and the whole financial structure. In early 1930 the provincial governments, and in late 1930 the central government acted to support the wheat price by guaranteeing the wheat purchasing pools of the prairie provinces. Drummond sees this as the crucial element in maintaining Canadian stability: 'A more serious collapse in wheat prices would have severely damaged Canada's banking system, and would probably have destroyed confidence in it.'

Several of the chapters focus on banking crises. Japan, where also there were many banks with long-standing industrial commitments, experienced a crisis in 1927: this collapse may have had the effect of convincing many leading bankers that it was better to obtain access to international capital markets that might be forthcoming under the gold exchange standard. The early crisis in Japan had, however, another effect: in retrospect it looks like a fine example of a preemptive purging. The financial restructuring that occurred in its wake

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was less painful and damaging in its effects on industrial lending than a similar operation carried out during the harshly deflationary conditions of the world economic crisis would have been. The Swedish and Netherlands crises of the early 1920s also similarly endowed those financial systems with increased immunity against the ills of the early 1930s.

1931 brought collapse in Austria, Hungary and Germany: destructively, in the middle of a world deflation as primary product prices suffered. In these conditions, the effects of deflation and the inherent weaknesses of mixed banking reinforced one another.

Italy had a latent banking crisis, as Forsyth demonstrates, as early as 1929: in other words, well before the events of 1931 in Central Europe could have had a contagious or knock-on effect. The crisis arose out of the declining prices and falling profitability of businesses: out of the pressure for deflation that followed Italy's choice of lira parity at the currency stabilization of 1927. The first banks to suffer were the small ones which did not possess the access to US capital markets enjoyed by their larger rivals.

By 1934, all the Belgian banks, with the exception of the giant Société Générale, were in such a weak position that they could no longer publish accounts; and the banking crisis required as a response the Belgian franc devaluation of 1935. Devaluation offered a path – one of the easiest and most promising – for the domestic management of monetary policy free of the need to transmit international deflationary pressures. In Central Europe, exchange control and voluntary agreements with creditors ('standstill agreements') or even moratoria on debt were another way of generating a new autonomy.

(3) Deflations and subsequent bank collapses led to large-scale restructurings of financial systems. Fletcher gives a powerful example when he describes the absorption of local – city and regional – banks in the course of an officially encouraged 'bank consolidation movement'. The 1927 Bank Law followed the severe financial crisis of that year, and the 'absence of opposition' (p. 260) to the new legislation was presumably a response to the destruction and havoc that had already been wrought. In Europe, the most dramatic restructuring took place in Italy. The large commercial banks were nationalized and their industrial participations separated out in the new state holding company Istituto di Riconstruzione Industriale (IRI). In Austria, the

Credit-Anstalt passed into state control, and two large Viennese banks – the Allgemeine Österreichische Boden-Credit-Anstalt and the Wiener Bankverein – were absorbed into it. For Germany, Feldman describes the 1933 Bank Inquiry and the 1934 Banking Law. In Sweden a law of 1933 attempted to halt an incipient mixed banking system by forbidding the ownership by banks of industrial shares (though the banks were given until 1938 to comply, and then they often evaded the control by setting up exempt non-banking subsidiaries). In Belgium, a decree of 1935 ended mixed banking and laid down auditing and supervisory requirements. In France in 1936 the Banque de France was put under state control, and schemes for the nationalization of private banks (actually put into effect only after the Second World War) prepared.

In all these cases, the position of banks became a highly political issue: not just one that could be examined from a pure standpoint of economic rationality. The reaction to crisis everywhere was greater state intervention in banking – ranging in scope from increased regulation (restrictions on activity; auditing requirements; limitation of credits in relation to size; limitation or prohibition of equity holdings) through state direct control (directed lending) and ownership as in Austria and Italy.

What consequences did restructuring – or attempts at restructuring, such as the hotly discussed Economic Bank described by Feldman – have on economic performance? The plan for an Economic Bank originated as a response to a widely perceived failure of German banks to play their historic role in assisting German industry and commerce. Larsson details a similar and contemporaneous proposal in his paper on Sweden, where during the early 1920s deflation the government sought not only to restructure banking but also to create a new publicly owned commercial bank as a result of the banks' neglect of their mission.

The issue of the relationship between finance and the rest of the economy has long posed difficulties for historians of financial systems, who are often surprisingly and distressingly reluctant to provide assessments of the macroeconomic implications of their work.

On the whole the contributors to this volume are not favourably impressed by the activity of interwar banks (the Canadian example is exceptional). Feldman's contribution demonstrates graphically how violent upheavals – in his case the post-war inflation and hyperinflation – can lead to the formulation of narrowly defensive strategies 'that betrayed [banks'] limited capacity to cope with the problems of industrial reconstruction'. This conservatism continued to characterize the approach of German bankers after the end of the inflationary period: indeed they frequently interpreted the stabilization as requiring a return to sobriety and modestly limited horizons. Teichova shows how the Credit-Anstalt was particularly heavily associated with the older and most traditional Austrian industries – mining and metallurgy, engineering, textiles, wood, and brewing. Mosser complains about the 'lack of growth strategies' in Austrian industry. Mazower shows for Greece how the world depression was not accompanied by the type of cleansing that classical economists believed should take place in depressions: there was no disappearance of small antiquated and inefficient firms. Japan and Italy saw much greater rationalizations in the wake of banking disasters; but in their adaptations public policy played an important part. There is, however, no evidence that the more prominent role of state institutions led to a more effective investment policy on the part of Japanese or Italian industry in the course of the 1930s.

Banks provide an institutional way of assembling and exchanging large quantities of information about the economy, and thus lay a basis on which decisions can be made. The superior and intimate knowledge of many branches derived by the German-style universal banks at the end of the nineteenth century provided a greater input to rational decision making than that derived from a stock market where the rewards for concealment were high. Some observers attribute faster growth in late nineteenth-century Germany to this superior supply of information.[6] Systems of interlocking directorates provided ways of reducing market uncertainty and risk, and represented a response to a high degree of competition on the financial market.

This leaves the important and interesting question of what went wrong in the interwar economy? An obvious answer is that the political disruptions and the consequent alteration of circumstances were at the same time so great and so frequent that information changed too quickly for its regular supply to offer major advantages on making long-term decisions. There was a general contraction of time horizons, a living of life for the moment, that deprived the universal banks of what had previously been a major asset – superior access to reliable flows of information.