Introduction

> Politicians strut and fret their hour upon the stage, and then are heard no more. The real moving forces in the development of the economic and financial systems lie elsewhere. *The Banker* April 1996, 96.

This book is about moving money within and across countries. It raises the following question: are the few percentage points of my income that I save each month lent to a firm in my neighborhood or do they end up refinancing the short-term debt of the Republic of Mali instead? The answer to this question does not depend on technology, for, since the telegraph was invented, money has had the capacity to move to almost any urban area in the world at the speed of electromagnetic waves. Nor is the answer more likely to be found in economic reasoning. The local firm and the foreign government, holding risk constant, will pay the same interest on the sums they borrow. The answer, instead, is political. My savings are more likely to help fund production in my local industrial district if I live in Germany, Italy, Canada, or the United States, but to end up in Timbuktu if I live in Britain or France. Mobility of capital reflects the degree of centralization of the state. It is the structure of the state that determines the outreach of the "great go-between," Bagehot's phrase for Britain's financial system, to which he ascribed the responsibility for moving money.

Many books are written on moving money, cross-border flows, and the mobility of the "K" factor – capital. But while most books associate capital mobility with global financial flows, currency markets, and direct foreign investment, the present work makes the unusual claim that capital mobility begins at home, between cities, between regions; mobility across districts is a prerequisite for mobility across countries.

It is easy to forget in these days of global market expansion that financial systems are nested in the politics of their respective nation-states. Irrespective of whether the state intervenes or not in the allocation of credit, whether *politicians strut*, *fret*, or *are heard no more*, politics is omnipresent through its institutions. The reason is that markets are not neutral, but

create winners and losers. Even in the best-ordered society, market discipline is not a credible mechanism for the allocation of wealth unless politicians manage the redistributional conflict, and deflect, accommodate, or buy off the victims' resistance to market competition. This reliance on politics accounts for the differences between financial markets. Different political institutions, reflecting different historical trajectories, articulate redistributive conflicts differently, shaping peculiar financial rules and structures.

This is a comparative study of how banks and financial markets are organized. The argument is that the degree of centralization of the state shapes how financial markets are organized. The level of state centralization is determinant because financial markets are centralizing mechanisms. Banks tend to cluster in financial centers. The savings that move to the center do not always flow back to the periphery to fund local, generally small investments. Capital mobility, instead, tends to be one-way. Financial centers drain the local economies of their financial resources, leaving behind a periphery of aggrieved local borrowers, banks, taxpayers, and governments. Decentralized state institutions empower these local peripheries, whereas centralized institutions do not. A good part of bank and financial regulation is designed to hinder the development of the center at the expense of the periphery, and this regulation is mostly found in decentralized countries. It is the centralized countries that regularly reach the highest levels of market liberalization – they have a financial center characterized by breadth, depth, functional specialization, and internationalization.

In contrast, decentralization foils financial liberalization. Decentralized countries rarely reach high levels of market liberalization. Their banks are dispersed, and market-induced specialization among banks is often circumscribed. Stock markets are shackled and internationalization is reduced. The US financial system is no exception to this rule. The United States is home to the largest concentration of bank assets and the largest stock capitalization in the world. But it owes its leading position to the absolute size of its economy and the wealth of its citizens, not to financial regulation.

This book tells a story. The prologue, which, as in children's tales, is brushed with sufficient historical imprecision to provide a convenient background to the unfolding drama, presents a tranquil era in which short-term bank resources took the form of banknotes and current accounts. The sudden arrival of the deposit, along with the check, opened up the first period of market expansion (1850s–1913), followed by a period of market contraction (1914–1960s), and then another period of market expansion (1960s–present). The first and last periods show

remarkable similarities. Competition intensified, banks grew larger, and geographic concentration in the sector increased. Domestic markets were opened to foreign influence, foreign investment surged, and money and equity markets boomed. Parallels between 1900 and 2000 are striking enough to make the study of the past directly relevant to understanding the present, and to make us wonder if the past will keep repeating itself.

How financial systems are organized

In this work I shall consider four organizational dimensions along which financial systems are ordered: spatial concentration, internationalization, market development, and specialization. Financial systems vary, first, in terms of banking concentration. In Britain, France, and other centralized countries, a handful of very large banks manage nationwide *branch* networks. In contrast, in Germany, Italy, and other decentralized countries, more than half of the loan market is on the books of savings banks – institutions with a quintessentially local reach. In the United States and Norway – two decentralized countries – one still encounters cases of *unit* (single agency) banking.

The second dimension that is considered in this book is the degree of *internationalization* of the capital market. The capital market is highly dependent on cross-border capital flows in Belgium, Portugal, and Britain, whereas it is closer to self-sufficiency in Japan, Iceland, Germany, and Italy.

The third dimension is *intermediation* – the importance of banks relative to securities markets in the supply of external finance to firms. In centralized Britain, France, and the Netherlands, markets have traditionally been dominant, whereas in decentralized Germany, Italy, and Scandinavia, banks have acted as intermediaries between investor and borrower.

The last dimension is the degree of *specialization* of banking. In centralized countries, Britain especially, banks traditionally specialize in one or two activities – commercial paper, lending, flotations, savings, mortgages, and so on. However, in many, though not all, decentralized countries – Germany is a good example – banks have traditionally been *universal*, providing almost all services under one roof.

Concentration, internationalization, market development, and specialization are the four dependent variables of this study. The explanatory power of state centralization, however, does not stop at these four dimensions. I have written elsewhere on the role played by state structures in determining the relative importance of *state banking* – when the state is

directly involved in the allocation of a substantial share of loans. I have also touched on the notion of financial *stability* – when banks show resilience in the face of liquidity crises. Linked to the notion of stability is the early establishment of central banking and *lending-of-last resort* across countries.[1]

Case selection and methodology

The method is comparative. I look at financial systems in fifteen to twenty advanced industrial countries, depending on the period. Case selection is dictated by data availability, which, in turn, is a function of financial development itself. Fifteen to twenty is a methodologically inconvenient number of cases. I have attempted to mitigate this problem by relying on the graphic representation of bivariate relationships and using small-*n*-friendly statistics. To present results and identify outliers, I rely on partial regression plots – the multivariate analog of the bivariate scattergram.[2] When the variables are asymmetrically distributed and/or the number of observations drops too low, I bootstrap the statistics.[3] Given data limitations, it would be a mistake to try to squeeze too much out of the data. Conviction, if it will come at all, will not come out of any single statistics – none was designed to withstand econometricians' scrutiny – but from considering the entire body of evidence together.

Merely adding new cases does not always make good econometric sense. Including a handful of undeveloped countries would, in addition to adding imprecision to the data, raise the risk of non-linear and poorly understood variations, expanding the dataset to be sure, but not necessarily adding meaningful degrees of freedom. It would also increase the degree of interdependence between observations. The greater the developmental gap between countries, the less independent are the observations. Banking in Argentina at the turn of the century exhibited the same structural traits as British banking, not because domestic conditions were identical in the two countries – they were not – but because banking in Buenos Aires was run by the local branches of British banks.

[1] On state banking and financial stability, see Verdier 2000 and 1997 respectively.
[2] Each plot generates a coefficient and a fit that are equal to the coefficient and fit of the dependent variable against the chosen right-hand-side variable, while simultaneously controlling for the effect of the other right-hand-side variables on both variables. See Bollen and Jackman 1990.
[3] Bootstrapping is a non-parametric technique that makes it possible to get around the size constraint ($n > 30$) imposed by the central limit theorem. Bootstrapping is also useful in the presence of variables that are distributed asymmetrically, multimodal, or truncated – a common occurrence in small samples. See Mooney and Duval 1993.

British international influence breached rule number one of comparative analysis – the independence of cases.

Of course, few cross-sectional observations in comparative politics are ever entirely independent, as governments learn from one another, mimicking policies that seem to work elsewhere, while screening out those that fail. This is especially true in matters of finance, and even more so when cash crosses borders. Yet the ongoing globalization of the world economy does not disqualify the use of the comparative method in this research. My argument is that variations in political institutions explain variations in financial structures. This claim is untestable only if case contamination affects the institutional variable, not if it affects financial structures. If globalization is strong, then financial structures should converge despite any parallel lack of change in institutional features, thereby weakening or falsifying my working hypothesis. Economic convergence does not make the present research spurious, but merely presents it with a rival hypothesis.

At any rate, I do not argue that political institutions explain all, or even most, financial structures. Other aspects matter, such as wealth and economic growth. At most, the empirical regularities that I shall identify may serve to suggest the plausibility of the argument. Although I will not refrain, whenever the opportunity arises, from pointing out the limitations of rival arguments, my sole aim is to introduce a new variable into the field of financial studies – a variable with a distinctive political content.

Organization of the book

The book has three parts. The first part is theoretical. It includes a survey of the literature on banks and financial markets and a statement of the full argument. The second and third parts cover the two golden periods of financial expansion: the market expansion of 1850–1913 and the market expansion of 1960–2000.[4] These two parts each have four chapters, respectively dealing with geographic concentration, internationalization, intermediation, and product specialization.

[4] The 1914–59 period was excluded from this book for methodological reasons that are given in chapter 2. For an account of this period, see Verdier 1997 and 2000.

Part I

Theoretical conjectures on banking, finance, and politics

1 Capital scarcity, capital mobility, and information asymmetry: a survey

Finance is a rich field of study, pooling contributions from historians, political scientists, and economists. My goal is not to draw up an exhaustive inventory of the existing literature, but merely to situate the approach adopted in this book. I successively look at (1) the historical debate on capital scarcity, on which I offer a new perspective; (2) the use by political economists of the notion of capital mobility, which I try to clarify; and (3) the economic literature on information asymmetry, on which I build my argument.[1]

Capital scarcity

In an article published in 1952, Gerschenkron provided the most ambitious explanation yet offered of why financial structures differ across nations. The more capital was needed in a short amount of time, he argued, the less equity markets could cope with the task of allocating long-term financial capital; instead, banks and state had to step in. Hence the "orderly system of graduated deviations from [the first] industrialization":[2] British industrialization was self- and market-financed, manufacturers ploughing back profits into their own factories; French industrialization (the 1850–70 spurt) was financed by investment bankers, who raised long-term capital and lent it to factories; German industrialization was financed by universal bankers, intermediating between depositors and factories; and Russian industrialization was financed by the state, raising capital from taxpayers and foreign lenders to distribute it to banks and factories. The need for banks or state intervention reflected economies of scale. Economies of scale were characteristic of late industrialization; the period was also lacking in standards of honesty and in adequate mechanisms for the enforcement of contracts.

[1] In a more diversified survey (Verdier 2002), I review eight additional approaches: (1) developmentalism, (2) fixed costs, (3) social capital, (4) institutional commitment, (5) legal origins, (6) market segmentation, (7) curb market, and (8) global convergence.
[2] Gerschenkron 1962, p. 44.

Gerschenkron's theory is a two-step argument. The first step links backwardness to the timing of industrialization. The second step links this timing to the organization of the financial system – the relative degrees of market, bank, and state intermediation in the provision of long-term capital. The first step has been heavily criticized on the grounds that not all backward economies industrialized, nor did all do so in a "big spurt."[3] The second step, the contribution of markets, banks, and the state to industrialization, has better stood the test of time. To be sure, the fit between the timing of industrialization and the type of credit system is far from perfect; there are cases (Italy and Austria) that exhibited the banking traits of late industrialization, despite the fact that their big spurt, by Gerschenkron's own admission, petered out. There is also Denmark, an economy that grew faster than Germany in the prewar decades and that developed universal banking, but without large-scale, capital-intensive industrialization.[4] Despite these limitations, historians have offered no generalizable alternative to Gerschenkron's argument.[5]

Zysman (1983) applied Gerschenkron's insights to the study of industrial policy in the postwar period. He proposed a threefold typology of banking systems, distinguishing between the French "state-led" model, the Anglo-Saxon "market-based" model, and the German-like "private-bank-organized" model.[6] This typology is very similar to Gerschenkron's triptych, with the difference that France, rather than Russia, is offered as the paradigm for state banking. The rationale for the choice of France reveals a key modification that political scientists brought to Gerschenkron's synthesis when they imported it. Of course there was a strong demand in postwar France for a quick rebuilding of the economy. But this was also the case almost everywhere in Europe. What made France paradigmatic in its credit policy was the specific institutional makeup of the French state – a "strong" state, in Zysman's terminology. For Gerschenkron, the

[3] Gerschenkron (1962, p. 234) himself grappled with the Bulgarian case, coining for the occasion the notion of "missed opportunity." For a thorough review of new developments in growth time-series since Gerschenkron, see Sylla and Toniolo 1991.

[4] Bairoch's (1993, p. 8) data for 1890–1913 show a 2.3 percent annual growth in GNP per capita for Denmark against 1.7 percent for Germany. On Denmark, see Gerschenkron 1962, pp. 16, 361.

[5] Gerschenkron's proposition that industrial capital shortage made continental banking less specialized than British banking is widely shared among economic historians. In a recent review of Gerschenkron's contribution, Sylla and Toniolo (1991, p. 24) wrote that "the 'loose' version of Gerschenkron's paradigm still offers a good first insight into [the problem of European industrialization] and provides a powerful guide in framing the meaningful questions that scholars should ask." Still, very few historians have endorsed Gerschenkron's synthesis. An exception is Jon Cohen (1967).

[6] For a similar argument, see Hu 1984. Knutsen (1997, 108) endorsed Zysman's typology in his study of postwar Norwegian banking.

state is a possible substitute for market failure that is a priori identically available across nations. For Zysman, and for Shonfield (1965) before him, states differ in their capacity to intervene in the economy in general, and in capital markets in particular, and this difference, very much like capital endowment in Gerschenkron's theory, is the fruit of a historical legacy.[7]

Gerschenkron left the causes of capital scarcity underexplored. Although it could be a shortage of capital in the national economy as a whole, the problem was most often a shortage of capital flowing to industry. Prussia is a case in point. No overall capital shortage existed there during the first half of the nineteenth century – in fact, Prussia exported capital. But this capital was not readily available to industry, as investors preferred government bonds.[8] To account for this fact, one needs to shift the emphasis away from the firms' demand for bank loans (in accounting terms, the assets side of a bank's balance sheet) toward the savers' supply of cash to banks (the liabilities side). Financial systems vary, I argue with Gerschenkron, because they enjoy differential access to capital. The cause of scarcity, however, does not lie in a temporary surge in the demand for capital, but in the sustained Malthusian regulation of centripetal capital flows in countries where local governments are politically powerful. In relation to the Gerschenkron–Zysman synthesis, the present study concurs that state structures matter as an explanatory variable. The question is: which aspect of state structures? Political scientists working in Zysman's footsteps have so far put much weight on the elusive notion of state autonomy and political insulation. Instead, I emphasize the intuitive and measurable notion of state centralization.

Capital mobility

Capital is a factor of production, and factor mobility is a key parameter in political economy models. Such models typically seek to derive the regulatory outcome from a policy process in which firms, factors, and

[7] The notion that state allocation of credit is superior to market allocation in situations of industrial catchup has been qualified by Loriaux (1991) in a study of postwar France and Pérez (1997a) in a study of postwar Spain. The Gerschenkron–Zysman synthesis generally found greater support in studies of East Asian finance; see Wade 1985 and Woo 1991. Yet, even there, Haggard and Lee expressed caution about the risks of "predation and patrimonialism" (1993, p. 20). The works of Rosenbluth (1989) and Calder (1993) on the Japanese financial system sought to debunk the myth of the "strong" Japanese state. The debate critically hinges on the definition of state strength, a synthetic and tautology-prone concept.

[8] See Barrett Whale 1968, p. 11; Tilly 1967, p. 156; Schmoller 1904, vol. II, p. 182; Joseph Hansen 1906, vol. I, pp. 580–86; Beckerath 1954, pp. 7–14; Borchardt 1961.

politicians pursue their respective policy preferences.[9] Factor mobility usually enters the model as a parameter in the determination of economic actors' policy preferences. If mobile across sectors, capital merely exits from a sector that becomes unprofitable. In contrast, if capital is specific to a sector, it faces a choice between retooling the sector or lobbying for government support for that sector.

Some studies try to determine the causes of capital mobility or, inversely, capital specificity. This "asset-specificity" literature, as it is known, typically points to sectoral barriers to entry. Instances of entry barriers include sunk investment costs, R&D intensity, learning by doing, brand names, and patents.[10] In a study of Norwegian firms, Alt et al. argue that firms with large R&D expenditures create specific assets for the manufacture of products with no close substitutes, which are difficult to dispose of if there is no demand for the product. As a result, Alt et al. argue, R&D-intensive firms have a clear propensity to lobby for subsidies or market protection.[11]

The asset-specificity literature rests on a notion of capital that is made up of dissimilar elements. Capital comes in two forms: (1) *production* capital, which comprises machinery, stock, and the buildings that house them, as well as intangibles like patents, and (2) *financial* capital, referring to all financial assets, long and short. The asset-specificity literature does not deal with the dichotomy well. Either that literature shuns financial capital to concentrate its attention on production capital exclusively;[12] or, alternatively, it treats production and financial capital as separate factors of production, with the latter more mobile than the former.[13]

Treating finance as an intermediate sector between savers and borrowers brings clarity to the analysis. Physical capital is, almost by definition, fixed. Unbolting a piece of machinery for relocation is a costly business

[9] For a useful typology of models, see Rodrik 1995.
[10] See Frieden 1991, Hiscox 1997, and Alt et al. 1999.
[11] Alt et al. 1999, 109. The literature also identifies political determinants of capital mobility. Alt and Gilligan (1994) argue (though do not show) that the electoral rule shapes the scope of public policy and the degree to which a firm will invest in specific assets. If members of parliament are tied to single-member districts, they provide the protection that keeps firms tied to a specific location. If they do not represent geographically based constituencies, but are elected from a national list of candidates, they may still provide protection, yet not of the kind that ties firms to a location. I have argued elsewhere that factor specificity is a sociopolitical construct, reflected in asset holders' membership in networks (Verdier 1995).
[12] See, for instance, Frieden and Rogowski 1996, p. 27.
[13] For instance, Frieden (1991, 438) writes: "it is consonant with the specific-factors approach to assume that . . . financial capital is mobile among industries, while physical capital is industry-specific." Frieden further separates financial capital into bonds and debt, said to be mobile across countries, and stocks, which are less so (ibid., 429).