Finance, Intermediaries, and Economic Development

Edited by

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Finance, Intermediaries, and Economic Development

This volume includes ten essays dealing with financial and other forms of economic intermediation in Europe, Canada, and the United States since the seventeenth century. Each relates the development of institutions to economic change and describes their evolution over time. Several different forms of intermediation are discussed, and these essays deal with significant economic and historical issues.

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Preface

This volume contains papers first presented at a conference, "In Data Veritas: Institutions and Growth in Economic History," held in honor of Lance Davis at the California Institute of Technology, November 6–8, 1998. In addition to the presenters, also attending, as formal or informal discussants, were Karen Clay, Robert Cull, Price Fishback, Albert Fishlow, Stephen Haber, John James, Shawn Kantor, Zorina Khan, Margaret Levenstein, Rebecca Menes, Clayne Pope, and John Wallis. The Introduction and the Afterword were written by the editors at a later date. We wish to thank Frank Smith from Cambridge University Press and the two anonymous referees for the Press for very helpful suggestions.

We wish to acknowledge the administrative help of Susan G. Davis and the financial help of the Division of the Humanities and Social Sciences, California Institute of Technology, in the conference arrangements. In preparing the final manuscript we were aided by the Department of Economics, University of Rochester; the Department of Economics, UCLA; and the Division of the Humanities and Social Sciences, California Institute of Technology. In the process of publication, we benefited from the editorial work of Michie Shaw of TechBooks, the copyediting of Carol Sirkus, and the preparation of the index by Kathleen Paparchontis. But most of all we gained from the scholarship and enthusiasm of Lance Davis.

Contents

Introduction

One of the striking changes accompanying – if not helping to cause – economic development is the dramatic increase in financial transactions among firms and individuals, sometimes directly between borrowers and lenders, sometimes involving third parties (financial intermediaries).[1] Over time these third parties played an increasingly important role. In part it is because the type of intermediaries who appeared early on (brokers, banks, stock markets) grew more numerous; and in part it is because of the introduction of totally new institutions (legal institutions and informal rules of behavior) and totally new organizations (savings and loan associations, investment trusts, and central banks). In most societies this expansion of financial intermediation fueled higher rates of savings and investment, more rapid growth of the capital stock, and a higher rate of economic growth.

The big question here is how financial intermediaries facilitate investment. Lance Davis has long maintained that intermediation acts both on supply, the magnitude of investment funds, and demand, the choice of projects these funds will support. In the early stages of growth, the key issue lies in mobilizing the available savings rather than increasing its amount. Mobilization occurs when savers increase the relative size of their financial holdings. The decision to do so depends on financial institutions that provide savers with information and diminish the risk they bear. Such a task is not easy, for savers appear to be creatures of habit. Davis has gone so far as to argue that savers must actually be taught to hold financial claims (Davis and Cull 1994). Similarly, when economies begin to develop, they experience structural change. Resources must, therefore, flow to new sectors and new regions in the economy, and investment must be reallocated. Here financial intermediaries play a critical role in allocating funds to different projects, particularly to new

[1] The correlation between financial deepening and economic growth has long been established. Summary information for a number of countries was compiled by Goldsmith (1969).

firms or those dependent on external finance. Information, of course, plays an important role. Intermediaries specialize in information gathering and must acquire the information about the quality of investment projects and perform other services for entrepreneurs. If financial intermediaries are successful in their twin tasks of mobilization and allocation, then capital will flow from savers to entrepreneurs, from parts of the globe where returns are low to parts of the globe where they are higher. Here Davis has put considerable emphasis on the public and private rules that govern financial intermediation and on the interaction between government regulation and private institutional innovation (see Davis and Huttenback 1986; Davis and Cull 1994; and Davis and Neal 1998). It is studying these rules that allows us to understand why some forms of financial intermediation have been successful although others proved to be failures.

Success comes from a subtle interplay between government and the private sector. On the one hand, financial markets can easily fail or fall victim to panics. If the government can intervene in a way that reassures savers and makes them believe that financial intermediaries deserve their trust, then financial crises will have only temporary effects, and the development of capital markets will continue almost unabated. But if the government acts with too heavy a hand, then, as Davis and Gallman (2001) emphasize, it will stifle financial innovation and obstruct the allocative role played by financial intermediaries. Innovation is particularly important here, for it often brings on failure and thus a greater temptation for the government to intercede.

Lance Davis's investigations of financial intermediation have been very broad-ranging, including not only examination of interest rates and rates of return (Davis 1965) but also the study of the amounts of funds transferred. Beyond interest rates, he has also devoted considerable attention to measuring capital flows and their economic return over the long run (Davis and Gallman 1978), thereby raising questions about the evolution of the rules that structured the movement of capital. Research on such questions made Davis one of the first to stress the importance of political economy for understanding both domestic and international financial structures and the relationship between financial development and economic growth (Davis and North 1971; Davis and Huttenback 1986). The collections of essays we present here all follow Davis's lead in going beyond questions about prices and quantities to questions of institutions.

Such an emphasis on political economy has much relevance in economics today. To begin, consider the empirical debates raging over the role of transparency and legal origins in financial development (e.g., La Porta et al. 1997; Beck, Levine, and Loayza 2000; Rajan and Zingales 2001). The authors engaged in this debate have used recent data on economic and financial performance and long-term indicators of financial development to ask what role institutions play in growth. They have certainly asked important questions, such as why is economic growth slower in developing countries that inherited a French legal code or in countries with limited European settlement or in countries with a legacy of extreme inequality or abundant land relative to labor? (Acemoglu, Johnson, and Robinson 2001; Engerman and Sokoloff 1997; La Porta et al. 1998). But the recent data alone cannot answer these questions; it can only help frame them. The answers have to come from a long-term focus that is the stock-in-trade of economic historians. They and other scholars with the long-term focus that these issues demand can begin to address these questions. In the same fashion, debates about financial systems ask important questions that can only be answered with a historical perspective. Currently, scholars are fond of contrasting British and American financial systems that rely heavily on equity markets with German ones that favor banks (e.g., Calomiris 1995; Guinnane 2002). The last decade of the twentieth century was a heady time for the United States and other stock exchange-based economies, and it might seem reasonable to decide, therefore, that equity markets are superior to banks, even though Germany's difficulties probably have more to do with the costs of unification than with the fluctuations of its banking system. Yet, before German and Japanese financial structures are confined to the historical dustbin, we should bear in mind the stellar long-term performance of both economies during the long period from 1870 to 1990. Which financial system is better at promoting long-term growth, even with fluctuations, is thus still an unsettled question, and answering it will necessarily involve economic history. It also will have to take into account political economy and do so in two ways: first, because governments bear much responsibility for the original structure of financial institutions; and second, because governments are themselves major consumers of financial resources and their thirst for debt is almost unquenchable.

This volume follows Davis's call for research on the role of financial institutions and intermediaries in economic development, although it does not provide final answers to all the questions he has raised – a task that would take far more than a single volume. In particular, the volume takes a broad view of finance and intermediation, as it examines changes in England, France, Canada, and the United States over the past several centuries. A first set of essays probes the evolution and impact of differing financial institutions in two European countries. Larry Neal and Stephen Quinn analyze the role of bankers and merchants in the development of London as a major center of European finance in the seventeenth century. They put special emphasis on the innovation of private and decentralized clearing systems in London. Philip T. Hoffman, Gilles Postel-Vinay, and Jean-Laurent Rosenthal then focus on the competition during the first half of the nineteenth century between two important Parisian financial intermediaries, bankers and notaries. They argue that this competition drove innovation and risk taking in the financial system. Angela Redish next describes the importance of the mortgage market in Ontario, Canada, in the first half of the nineteenth century. Dianne Newell sketches the developing west coast salmon cannery industry in the late nineteenth and early twentieth centuries, with stress on the means and mechanisms of intra- and inter-ethnic entrepreneurial borrowings. John Legler and Richard Sylla evaluate the performance of the stock market in the U.S. South after the Civil War. And the final paper in the Americas section, by Ken Snowden, deals with the initial rise and collapse of a financial institution of more limited scope but of great importance to local economic development in the United States – savings and loan associations.

Together, this group of essays stresses the role of private enterprise in the development of financial markets. All the chapters take the legal and political context as given and downplay the role of political and administrative reforms. They in fact imply that what enabled private initiative was not reform but rather benign public neglect – public neglect in the context of a relatively stable legal and political structure. In this setting, financial innovation took place when new intermediaries appeared or old ones delved into new areas of finance. Both Neal and Quinn and Hoffman, Postel-Vinay, and Rosenthal go even further: They point out how financial crises, far from always being disasters for financial markets, can sometimes generate responses that promote financial innovation. One broad implication of their research and of the other essays in this first group is, therefore, a call for a new direction in current research on institutions, particularly legal ones. In particular, the legal factors that scholars currently devote so much attention to are in fact unlikely to explain the secular evolution of financial markets in developed economies. Prior to World War II at least, North America and Northwest Europe grew despite different legal regimes and despite periodic bouts of political and economic instability. Economic growth was widespread because politicians in these countries recognized how important finance was, and they, therefore, allowed a broad array of private financial intermediaries to operate. This broad array allowed the financial sector to quickly respond to new challenges as the economy developed

The second set of essays in the volume deal with a broad view of finance and intermediation. We now recognize that capital flows are quite complex processes. We must begin by acknowledging that nonfinancial assets have had a significant effect on economic change and that they are often transferred through channels other than banks or brokerage houses. Hence, it is worthwhile to integrate the study of financial markets with the study of other asset markets. In a different vein, the development of financial institutions also entails a significant role for politics. Governments are after all important borrowers or lenders, and thus they care directly about financial markets. Moreover, governments provide the regulatory framework for asset markets, and they tend to get more involved with these markets as economic development proceeds. At the same time, governments can use fiscal policies to redistribute incomes among individuals, as well as political units, leaving an impact on relative economic growth and distribution and affecting the demand in asset markets. As a result, governments can either promote private asset markets or discourage them.

The major issues in the second set of essays relate to the transmission of assets, broadly defined. Two of the essays focus on the private sector. In the first, Naomi Lamoreaux and Kenneth Sokoloff examine intellectual property rights. Their essay, which takes up an understudied aspect of the market for technology, underscores the importance of trade in patents among individuals and firms, both directly and with the assistance of specialized intermediaries. In the case of the market for technology, intermediation arose to facilitate the transfer of new technologies from inventors to those firms best positioned to commercially exploit them. But that market was based on the government's patent system. In a similar vein, Eugene White describes how the Paris Bourse emerged in the eighteenth and nineteenth centuries. Early on this market focused on privately held government securities, but the government continuously intervened to limit innovation by the Bourse. The government intervention, in turn, reduced the importance of the stock exchange in the French economy. The final two papers place the government even closer to center stage: Robert Allen describes the role of finance in Soviet economic development between 1928 and 1939, explaining the battery of measures put in place by the central planning authorities to raise investment rates in manufacturing. Finally, Michael Bordo, Michael Edelstein, and Hugh Rockoff focus on how the adoption of the gold standard during the interwar period promoted the existence of an important intangible asset, financial credibility.

This second group of essays highlights the tremendous complementarities between public and private institutions: For instance, a market for intellectual property rights can hardly exist without patents, but the value of patents, in turn, depends on private agents and institutions. They also emphasize the uneven relationship between private and public institutions when it comes to finance: The government exerts tremendous influence on the structure of these markets, on the assets that get traded, and (at least in the twentieth century) on the direction of investment flows. Although the Soviet Union is clearly an extreme case, in the twentieth century most governments rich or poor have intervened heavily in capital markets via development banks, capital flow restrictions, or distortionary taxation. Issues of monetary stability, public and private institutional coordination, and investment flows are often thought to be modern problems, but as these essays show, they have a long history, even before globalization.

If this volume has any single lesson, it is that finance and intermediaries are critical to the process of economic growth. Intermediaries make possible more effective exchange in an economy; they also create developed markets that link nations together via flows of capital. To succeed, however, the intermediaries must inspire confidence in savers, a difficult task given the obstacles to creating and maintaining trust. Among the many obstacles are macroeconomic risks like inflation, government intervention, limitations of the legal system, and microeconomic hazards – not least of which is the fear that the intermediary will exploit his position of trust for his own benefit. Hence, the economic history of these intermediaries is often two faced, extolling their virtues on the one hand but also assailing them for the crises they provoke on the other. Although many observers have complained about the instability that banks and other financial intermediaries have periodically caused, instability is an inherent part of the process of growth, and we must not forget that these intermediaries have been a key element in the process of economic growth in those countries lucky enough to have achieved it.

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FINANCIAL INTERMEDIARIES IN EUROPE